BANK OF CANADA, Ottawa

ANNUAL REPORT OF THE GOVERNOR TO THE MINISTER OF FINANCE

AND STATEMENT OF ACCOUNTS

FOR THE YEAR 1965

BANK OF CANADA *Ottawa 4*

February 28th, 1966.

The Hon. Mitchell Sharp, P. C.,
Minister of Finance,
Ottawa, Ontario.

Dear Sir,

In accordance with the provisions of the Bank of Canada Act I am transmitting herewith my report for the year 1965 and a statement of the Bank's accounts for this period which is signed and certified in the manner prescribed in the by-laws of the Bank.

Yours very truly,

L. Rasminsky

Governor

BANK OF CANADA

Report of the Governor — 1965

As the economy moved towards the completion of its fifth year of expansion, indications were becoming increasingly numerous that virtually all of the slack existing at the beginning of the expansion had been taken up. The further impressive increase of 6½ per cent in real output in 1965 had reduced the unemployment rate to 3½ per cent by the last months of the year. Shortages of skilled labour and professional workers were becoming more numerous, more industries were working at or close to capacity, costs and prices were rising at a significantly higher rate, and the current account deficit in our balance of payments was widening.

Fortunately the productive capacity of the economy is growing and can be expected to continue to grow at a substantial rate. The main sources of growth are the rapid increase in the labour force and the prospective improvement in productivity associated in part with recent high levels of investment in plant and equipment. Public policy should continue to aim at providing conditions, including an adequate level of total demand, which encourage the economy to expand in accordance with the increase in its effective capacity. But in the immediate future our capacity to grow depends essentially on the factors just mentioned, namely the prospective increases in the labour force and in productivity, and can no longer be augmented quickly by any significant reduction in the amount of slack in the economy.

The output of the economy in 1965 could have been even higher if our productivity performance had been better. The productivity gains which accompanied the reduction in the margin of unused resources over the past year or so have been disappointing. This underlines the need for emphasis on policies bearing on "the supply side" of the economy which enhance our ability to produce. It is also the case that unemployment is still high in some areas, and output would be greater if the remaining pockets of unused resources were drawn into employment. In present circumstances, however, this is a task for those policies which are aimed directly at particular areas where unused resources exist; it is not one that can be handled satisfactorily by increasing the general pressure of demand in the economy.

In the present condition of high prosperity, the formulation of public policies intended to influence the total demand for goods and services poses peculiarly challenging problems. On the one hand, it is necessary to avoid a shortfall in total demand, which would result in increased unemployment and unused capacity. On the other hand, it is necessary to be alert to the dangers of excessive demand. The early symptoms in this latter case may not arouse as much public concern. Unfortunately, if the warning signals are ignored and policy does not respond until a large number of unsustainable positions have been created, until costs and prices have risen very sharply and international competitiveness has been impaired, then the problem becomes much more difficult to deal with in a way that will not halt the expansion of the economy.

At the present time, against the background of continuing vigorous expansion in the United States, a number of domestic factors are combining to produce very strong demands on our resources. Private business is engaging in a major round of capital expenditures. The public sector of the economy is proceeding with a rapidly growing volume of capital outlays on educational facilities, hospitals, highways and other social capital while at the same time increasing its other expenditures. Consumers are well placed, as a result of rapidly growing employment and rising wages and salaries, to increase their spending substantially. In these circumstances, the aggregate of all demands on the Canadian economy may outrun the effective capacity of the economy to increase its output of goods and services. In short, we now run the risk of overloading the economy.

MONETARY POLICY AND CREDIT CONDITIONS. The monetary policy of the Bank of Canada, like that of any central bank, must take into account both domestic conditions and developments affecting the external financial position. In 1965 the main domestic consideration influencing monetary policy was the fact that the slack in the economy was being taken up and the pressure on our resources was increasing. A special domestic factor with which the central bank had to cope and which affected its operations in 1965 was the risk that the default in June of a medium-sized sales finance company might have wider repercussions on the credit system. Under the impact of a much larger increase in imports than in exports, the current account deficit in our international payments was rising, even with the benefit of another large sale of wheat to the Soviet Union. The special measures taken by the United States Government beginning in February to improve that country's balance of international payments through the issue of "guidelines" affected our position in various ways; and it was of course necessary to take into account the agreement reached with the United States in 1963 regarding our exemption from the Interest Equalization Tax and the level of our exchange reserves. The course of credit conditions in the United States also influenced us in developing our own policy.

The operations of the Bank in 1965 were conducted in the light of the various considerations referred to in the preceding paragraph. A chronological account of the way in which credit conditions in Canada developed in the course of the year is given in a later section of this Report (pages 24 to 27), and the highlights are summarized here.

So long as there was a good deal of slack in the economy the basic policy followed by the Bank was to avoid any significant tightening of credit conditions. Apart from the exchange crisis of 1962, credit conditions remained relatively stable through the first four years of the economic expansion and interest rates fluctuated within a fairly narrow range. In 1965, however, as the economy moved toward full utilization of resources, the heavy demands for funds were allowed to have an impact on credit conditions. With bank loans continuing to rise strongly through the year—by 20 per cent—the ratio of the banks' "more liquid" assets to total assets declined and they found it necessary to adopt more selective lending policies. Interest rates rose substantially during the year and a further upward movement occurred in the first two months of 1966.

Credit conditions in the United States also became less easy in 1965 and interest rates rose in the second half of the year and the early months of 1966. As a result, the rise in Canadian interest rates did not bring about any significant change in the spread between long-term interest rates in Canada and the United States over the year as a whole. Taken in conjunction with the other factors operating, the spreads in interest rates were adequate to encourage the import of capital on the scale needed to cover our current account deficit without leading to an excessive accumulation of reserves. A bulge in our reserves in the latter part of 1965 was associated with exchange inflows resulting from the large sale of wheat to the Soviet Union and did not lead to any important change in monetary policy.

In the course of 1965 there was a pronounced shift in the form in which the Canadian public chose to hold its short-term financial claims. Broadly, the public chose to hold a significantly higher proportion of its liquid assets in the form of Canadian dollar savings and term deposits with banks and a lower proportion in such forms as foreign currency deposits with banks and short-term claims on non-bank institutions. To some extent this shift in holdings occurred in response to changed interest-rate relationships, though other factors, discussed on pages 29 to 32, were also at work. Non-resident holdings of Canadian short-term paper were reduced and there was some shift to Canadian sources of short-term finance, particularly the chartered banks.

The increase in currency and chartered bank demand deposits held by the public in 1965 was only a little greater than in 1964—6.5 per cent compared to 6.3 per cent. However, as indicated above, there was a substantial shift from other types of short-term assets to Canadian dollar claims on banks in the form

of savings deposits and interest-bearing term deposits of various types and the total of currency and chartered bank Canadian dollar deposits held by the public increased by 12 per cent compared with 7½ per cent in 1964. If Government deposits are included, the increase was 12 per cent in 1965 compared with 6 per cent in 1964. The increase in the money supply took place in an environment in which interest rates were rising and less easy credit conditions were developing, and a significantly smaller increase would have resulted in tighter credit conditions than the Bank considered appropriate in the circumstances of the time. The rate of increase in the money supply levelled off in the latter part of 1965, after allowing for seasonal factors.

The 1965 experience provides a clear illustration of the general approach followed by the Bank in carrying out its operations. This was explained in the Submissions of the Bank of Canada to the Royal Commission on Banking and Finance, May 31, 1962 in the following terms:

> "Although it would be possible for the Bank of Canada, with its power to control the cash reserves of the chartered banks within narrow limits, to operate on the basis of a precise view about the appropriate trend, over some period, of total chartered bank assets (or of the 'money supply', in the sense of currency outside banks plus chartered bank deposits), it does not in practice do so. The central bank is, of course, inevitably influenced in its judgments by developments in the 'money supply', but it must also take a view of the kind of credit conditions that would seem to be appropriate in the light of the current and prospective state of the economy including the external financial position and it must be prepared within limits to use its control of cash reserves as the situation develops in whatever direction is necessary to try to bring about and maintain those conditions. This may mean that on occasion the Bank of Canada allows changes in its own and in total chartered bank assets to absorb pressures developing in financial markets rather than see credit conditions tighten or ease to an undesirable extent."

Although monetary policy had to operate in 1965 in financial markets that were affected in important measure by external influences, including policy innovations in the form of United States guidelines, as well as by the disturbances arising out of the finance company default, I believe that credit conditions developed in a way that was broadly appropriate to the domestic economic situation and outlook. The fact, however, that monetary policy did have to take account of important external factors, including the reserve agreement with the United States, provides a clear reminder of one of its important characteristics, namely its influence on international capital flows, which may in certain circumstances be a limitation on its use. Another possible limitation is the uneven impact of extreme changes in credit conditions on different classes of borrowers.

The Bank has sought to follow a policy which took into account the possibility that the increase of total demand might outrun the growth in the effective

capacity of the economy. Monetary policy will continue to have an important role to play in this connection but extreme reliance on it would not produce satisfactory results. It is only one of the elements in public and private policy which must be adapted appropriately to changing circumstances if we are to achieve sound and sustainable growth.

CREDIT AND LIQUIDITY STANDARDS. The failure of Atlantic Acceptance in June had a disturbing impact on financial institutions and markets which was compounded by rumours regarding a trust company which had large investments in Atlantic and which was taken over by another trust company in September. There was some risk that soundly-managed institutions which had exercised prudence in the conduct of their business might find themselves in a position of difficulty and be unable to renew maturing short-term obligations until the confidence of investors had been restored. The dangers arising out of this situation were of major concern to the central bank.

Immediately after the default, the Bank of Canada added to the cash reserves of the chartered banks in order to ease the liquidity of the banking system and financial markets generally. Within a few days I consulted with the chartered banks and indicated to them that while I did not wish to influence their judgment as to the credit standing of any customer I hoped that they would not feel unable, for reasons relating to the total amount of their resources, to accommodate credit-worthy finance companies which might find themselves in a difficult liquidity position. This unusual step was taken because in the atmosphere prevailing at the time there was a risk that difficulties in any part of the credit system might have wider repercussions of a disturbing character. For their part, the chartered banks recognized that it was in the general interest that serious liquidity difficulties be avoided and their action in making additional credits available was helpful in the circumstances.

While the central bank is not entrusted with the function of appraising the soundness of the participants in the credit market, it is nevertheless very concerned with the maintenance of confidence in all parts of the financial system. Where such confidence is in danger of being seriously impaired the central bank may have to allow itself to be diverted from the pursuit of the current objectives of monetary policy and give priority to measures which help to maintain confidence. The events of last summer provided a dramatic illustration of the extent to which the whole financial system is dependent on the maintenance of high credit and liquidity standards, on the disclosure of adequate information, on the exercise of discrimination by investors and lenders, and on satisfactory arrangements for supervision and inspection of all parts of the credit system.

CANADA'S INTERNATIONAL POSITION. The current account deficit in our balance of payments increased by about $700 million to more than $1,100 million in 1965.

As a practical matter, current account deficits of this size can be financed only by obtaining large inflows of capital from the United States. This gives rise to special problems now that the United States is herself confronted with an over-all payments situation with which she is trying to deal mainly by restricting the outflow of capital. For the reasons I explained at some length in last year's Report the payments relations between the United States and Canada do not in fact impose a burden on the payments position of the United States: our net purchases of goods and services from the United States are substantially in excess of our imports of capital from that country. However, the balance of payments programmes of the United States are designed in the light of that country's position in relation to the world as a whole and Canada does not automatically obtain special treatment. This has to be negotiated with the United States authorities.

In the negotiations with the United States in July 1963 which provided that new issues of Canadian securities should be exempt from the Interest Equalization Tax, Canada stated that it would not be her desire or intention to use the proceeds of borrowing in the United States to add to her official reserves. The original "target" for official reserves was the June 30, 1963 figure of approximately $2,700 million. Later, after we had repaid our 1962 borrowings from the International Monetary Fund, it was agreed that any "net creditor position" which Canada had in the IMF should be regarded as a part of our official reserves for the purpose of the agreement.

I believe that the July 1963 agreement worked well. It provided us with the access to the U.S. capital market that we needed to cover our current account deficit. Though we naturally had to take the agreement regarding reserves into account, we were able to pursue a monetary policy which in its broad lines was appropriate to the requirements of our domestic situation as it developed.

The principal impact on Canada of the first United States guidelines issued in February 1965 was to encourage the repatriation to the United States of short-term financial assets held here by United States corporations. The effect of these short-term capital withdrawals on our international position was offset, however, in the way outlined on pages 38 and 39, by a simultaneous inflow of banking funds from overseas which was itself an indirect consequence of the guidelines.

In December 1965, the United States adopted an important new set of guidelines designed to eliminate the deficit in her over-all international payments in 1966. The principal features were (1) the establishment of a precise guide-

line for the purchase of long-term foreign securities by American non-bank financial institutions (insurance companies, pension funds, etc.) which limited the increase in these investments for each such institution to 5 per cent of the amount of its holdings on September 30, 1965 and (2) the establishment of a guideline on direct investment abroad—defined to include retained earnings as well as fresh capital flows—which permitted each corporation an average rate of direct investment abroad in 1965-66 up to 135 per cent of its 1962-64 average. As direct investment in 1965 was higher than this figure the guideline implied a cut-back in 1966. Canada was not exempted from the direct investment guideline.

The application to Canada of the guideline on the purchase of foreign securities by non-bank financial institutions would have had serious immediate effects on us. As a result of negotiations which took place, however, the United States, in addition to maintaining the Canadian exemption from the Interest Equalization Tax, agreed to exempt Canada from the guideline on non-bank financial institutions and to make it clear in the statement announcing this that United States investors were free to be guided by market considerations in deciding whether to buy new offerings of Canadian securities, i.e., that no moral suasion was to be applied to restrict such purchases. For its part, Canada agreed, as a contribution to the reduction in the over-all payments deficit sought by the United States Government, to reduce its "target" figure for reserves from the $2,700 million figure fixed in 1963 to $2,600 million. The Canadian Government stated that it would be prepared to repatriate its own securities held by investors in the United States if this proved necessary to maintain Canadian official reserves around the "target" level. By providing an additional direct technique for influencing our exchange reserves, this undertaking by the Government of Canada reduces the constraints on the use of monetary policy.

The limitation on our foreign exchange reserves embodied in the agreement is an undesirable feature from a Canadian point of view but from the United States point of view it is an essential one. It was the price which Canada paid to obtain access to the United States capital market for provincial and municipal governments and other Canadian borrowers which is both (1) unrestricted in amount through the securing of exemption from the guideline limiting purchases by the major United States investors of new long-term foreign securities, and (2) free of Interest Equalization Tax. Even if Canada had been willing to give up the exemption from the Interest Equalization Tax in order to avoid any commitment on our reserve levels, Canadian borrowing would still have been severely restricted by the operation of the guideline.

My comments on the direct investment guideline will be limited to its possible effects on our international capital account and on our domestic financial markets.

In view of the general character of the payments relations between Canada and the United States, it is clear that any substantial decline in direct investment inflows which results from this guideline will necessarily add to the amount of capital that Canada has to obtain from the United States market through new issues of long-term securities in order to finance our purchases of goods and services in the United States.

The application of the direct investment guideline to Canada could have important consequences on our domestic financial markets. If its effect were to increase substantially the amount of capital that subsidiaries of U.S. companies sought to raise in Canada from banks or the securities market, it could give rise to a distortion in our credit flows. With this danger in mind, I informed the chief executive officers of the larger chartered banks on December 10, immediately after the United States guidelines were published, that it was my hope and expectation that if the banks found themselves confronted with new applications for credit resulting from the United States guideline at a time when they were unable to meet in full the normal demands for business loans from their credit-worthy customers, they would continue to look after the customers who had relied on them in the past for their credit needs. The chief executive officers indicated that they agreed that this was the proper course to follow. I reiterated these views at a meeting with all the banks on January 5, 1966.

In commenting on this problem as it applies to securities markets, the Minister of Finance said in the House of Commons on February 2nd: "So far as long-term issues of American subsidiaries are concerned, I would hope and expect that there will be no abnormal recourse to the Canadian capital market, but if there were the Government would have to decide what action to take."

* * *

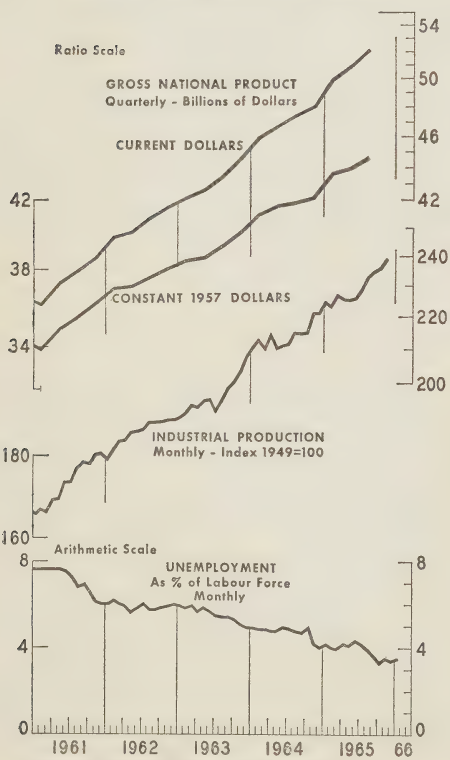
In spite of some difficult periods, we have been successful in obtaining financing of our large current account deficit under reasonably satisfactory conditions. But I believe that it would be unwise to take a detached view of the problems that arise from our dependence on continuing large imports of foreign capital. A situation in which Canada needs to import a great deal of capital from a country which is trying to restrict the export of capital is inherently unsatisfactory, and there is no easy or satisfactory way of dealing with it. It is undoubtedly the case that large net imports of capital enable us simultaneously to maintain higher levels of consumption and investment and government services than would otherwise be possible. But we would do well to bear in mind that Canada has no inherent right to import capital from abroad and that there are

many conflicting claims on the resources of the capital-exporting countries. While we must continue to make the best arrangements we can for access to foreign capital to protect ourselves against the possible need for difficult and concentrated adjustments, I believe that we should be aiming at a pattern of economic growth which, while providing for full utilization of our resources, involves reduced dependence on net capital inflows. This does not mean that we should adopt inward-looking attitudes. On the contrary it means that we must attach great importance to increasing our ability to compete effectively with foreign producers both in other countries and in Canada. It means that we should be increasingly concerned with maximizing our productivity and industrial efficiency, with up-grading our labour and management skills, and with keeping our costs and prices in line. It means too that we should pay increasing attention to the over-all effect of public policies on our capacity to provide from Canadian sources the flow of savings needed to develop our economy.

Economic Developments

The Canadian economy again moved strongly ahead in 1965, its fifth year of continuous expansion. By the end of the year goods and services were being produced at a physical rate one-third greater than in the first quarter of 1961 when the expansion began. For the second successive year the growth of the economy was greater than that of the United States and most other large industrial countries. The labour force and industrial capacity continued to rise, but employment increased rapidly enough to reduce the unemployment rate to its lowest level since 1956. For the first time since the mid-1950's pressure on resources was clearly developing.

OUTPUT AND UNEMPLOYMENT



Seasonally adjusted (GNP at annual rates).

Gross National Product rose by about 9½ per cent in current dollars in 1965. This slightly exceeded the increase of the previous year, but the margin over 1964 was due to a greater increase in prices—about 3 per cent compared with 2.3 per cent. The estimated gain in real output was about 6½ per cent in both years. Farm output, which had fallen in 1964, increased in 1965. The rise in non-farm output, about 6½ per cent, was somewhat smaller than in 1964, while the rise in non-farm employment, 4.8 per cent, was somewhat greater. Consequently, non-farm output per person employed—a very broad measure of productivity—showed a gain of less than 2 per cent, which was substantially less than the gain achieved in the previous year. The sources which provided the large increase in non-farm employment were a strong rise in the labour force, a sharp decline in farm employment and a further marked reduction

in unemployment. Unemployment fell from an annual average of 4.7 per cent of the labour force in 1964 to an annual average of 3.9 per cent in 1965. In the last quarter of the year the seasonally adjusted unemployment rate was down to 3.4 per cent. Further evidence of the strong demand for labour in 1965 was the frequency with which shortages of professional, technical and other skilled workers were reported.

The momentum of the economy in 1965 was reflected in a strong growth in incomes. Labour income, which had risen by more than 8½ per cent in 1964, increased by about 11 per cent in 1965. This reflected both the strong growth in employment and increased upward pressure on wage and salary scales. Corporate profits, which had risen by almost 15 per cent in 1964, showed a further increase of about 10 per cent in 1965.

The growing pressure of demand on the economy in 1965 gave rise to an adverse trend in domestic prices and in the balance on external trade. Although the principal measures of final prices were affected during the year by some special factors, it seems clear—both from the table below and the one on page 23—that prices were responding to influences of a more general nature and were beginning to rise more rapidly over a wide range of goods and services. Merchandise imports rose faster than domestic output and faster than exports, and the trend towards a declining current account deficit evident since 1959 was reversed in 1965.

SELECTED COMPONENTS OF GROSS NATIONAL EXPENDITURE

(percentage change from previous year)

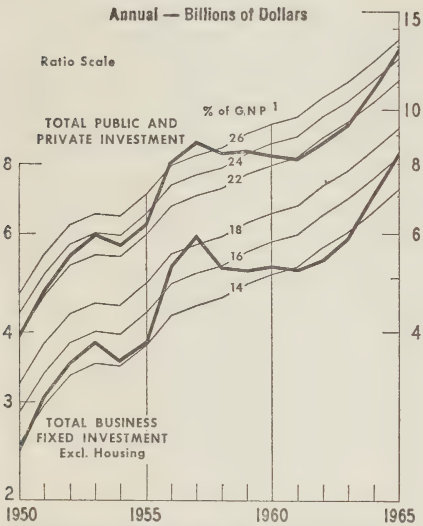
	Volume		Price		Value	
	1964	1965(1)	1964	1965(1)	1964	1965(1)
Personal expenditure	5.8	5.1	1.5	2.0	7.3	7.2
Government expenditure	4.4	6.3	2.6	3.7	7.3	10.1
Housing	12.0	3.4	5.7	5.1	18.4	8.7
Business investment	14.6	14.5	3.0	4.7	18.1	19.9
Total final domestic demand	7.0	6.6	2.1	2.9	9.2	9.7
Exports of goods and services	12.4	3.7	2.3	0.8	15.0	4.5
Imports of goods and services	11.3	10.6	1.7	0.1	13.2	10.7
GNE = GNP	6.5	6.3	2.3	2.9	8.9	9.3

(1) Change from first 9 months of 1964 to first 9 months of 1965. Some differences will be noted between these figures and those in the text which are based on estimates for the calendar year.

As the preceding table shows, all the main types of spending continued to increase in 1965. Business investment, which has been rising strongly since 1963, continued to be the most dynamic element in the expansion. For the year as a whole such investment is estimated to have gone up by a further 17 per cent

in value and 12-13 per cent in volume in 1965 following even larger percentage increases in 1964. The upswing in investment since 1963 has constituted the largest wave of investment activity in Canada since the mid-fifties. The rise has been less steep than in the earlier period when much of the increase was concentrated in the one year 1956. But the marked increase in the past two years brought the ratio of business investment to GNP up to a higher level than in any post-war year except 1956 and 1957. Investment in recent years appears to have been somewhat less strongly oriented towards resource development and supporting activities than was the case in 1955-57. Investment of this type has, of course, remained very important, but there has been a perceptible shift in emphasis from primary manufacturing, electric power development, oil and gas pipelines, and rail and water transportation systems to secondary manufacturing, urban transit systems, universities, office buildings and other commercial and financial services.

INVESTMENT EXPENDITURE



1. The contour lines enable one to see the ratio of investment to GNP in each year.

In 1965 as in 1964 there was a sharp upward revision of investment plans as the year progressed. The Department of Trade and Commerce survey of investment intentions made at the beginning of 1965 indicated that business fixed capital outlays would be about 13½ per cent higher in 1965 than they had been in 1964. It is now estimated that the actual increase over 1964 was 18 per cent in business expenditures on construction and 16½ per cent in outlays on machinery and equipment.

In view of the evidence that building activity was pressing on the capacity of the construction industry in many areas and was leading to a rapid increase in costs, the Government in August announced postponement of certain of its own projects and urged selective restraint by others. (For the same reasons, the Directors of the Bank of Canada postponed construction of the Bank's new head office building in Ottawa.)

Building of high-rise apartments and various forms of row housing expanded very rapidly during 1964 and the first half of 1965 but in the second half of the year, after allowing for seasonal factors, there was a fairly sharp reduction in the

number of multiple units started. In the past few years there has been little change in the annual rate of construction of single family dwellings. Residential construction taken as a whole was the only major sector of domestic expenditure to show an appreciably smaller increase in 1965 than in the previous year—about 5 per cent as against 18 per cent in 1964. Most of the increase shown for 1965 reflects higher prices rather than a rise in the physical volume of construction.

Personal consumption expenditures again increased strongly in 1965. In addition to the large rise in total wages and salaries already mentioned, personal income was further reinforced by a record level of farm cash receipts arising mainly from higher prices for livestock and the substantial receipts from the bumper grain crops harvested in Western Canada in the past three years. Even though there was an increase in the proportion of personal disposable income saved, consumer expenditures on goods and services rose by more than 7½ per cent in 1965. Spending on new cars was particularly strong. The number of new passenger cars sold, which had risen by 10 per cent in the previous year, increased by a further 15 per cent in 1965. Some of the difference between the two years reflects the impact of strikes which resulted in some spilling over of sales into 1965. There was also a continued trend towards more expensive models. The year 1965 was the fourth consecutive one of rapid expansion in the automobile market; during the period the number of passenger vehicles registered in Canada increased by about 25 per cent.

Expenditures by all levels of government on goods and services rose strongly in 1965. At the federal level, defence outlays continued to be relatively stable, but non-defence expenditures on goods and services rose by nearly 15 per cent. The total of provincial and municipal spending on goods and services, which has risen at an average annual rate of about 10 per cent in recent years, went up considerably faster in 1965. There was a particularly marked increase in capital outlays, mainly for schools and roads, but current expenses also rose substantially. In addition to the direct capital outlays of provincial and municipal governments which fall within the public sector, the outlays of their agencies and enterprises account for an important part of the rise in business fixed investment already referred to, notably in electric power development and urban transit.

Direct purchases of goods and services by all levels of government represented over 18 per cent of GNP in 1965. Provincial and municipal outlays on goods and services, at more than 12 per cent of GNP, were approximately double those of the federal government. This is a marked change from the situation a decade ago when the provincial-municipal share was about 8½ per cent of GNP and the federal share about 9½ per cent. Taking account of transfer payments to the private sector, including the rapidly rising disbursements to hospitals and universities, expenditures by all levels of government in 1965 were equivalent to

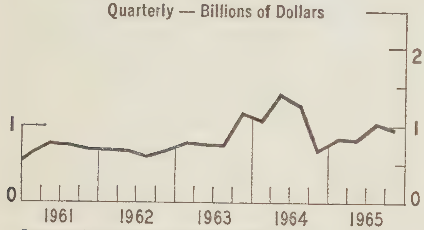
more than 30 per cent of GNP. The comparable ratio a decade ago was just under 27 per cent.

Despite the reduction in federal income tax rates which became effective at mid-year, the federal government's net fiscal position on a national accounts basis improved by about $220 million in 1965. This was about one-third of the improvement which took place in 1964. The combined deficit of provincial and municipal governments narrowed slightly in the early part of 1965, partly as a result of increased federal income tax abatements in favour of the provinces, but widened again as the year progressed.

Merchandise exports rose by only 6 per cent in 1965 after rising by 16 per cent in 1964. Wheat and flour shipments were about $175 million below their exceptionally high 1964 level, while exports other than wheat increased by 9 per cent in 1965 compared with 15 per cent in 1964.

Sales of wheat and flour under the first major contract with the Soviet Union added nearly $500 million to Canadian exports between September 1963 and July 1964. With the completion of these shipments wheat exports dropped in the latter part of 1964. They rose gradually in the first half of 1965. Through this period sales to regular markets remained very strong. Following the announcement in August 1965 of the second major contract with the Soviet Union, the physical volume of wheat shipments rose to the limit that could be handled by available transportation and marketing facilities. The total value of exports under the Soviet agreement amounted to about $200 million in the second half of 1965 with the balance, more than $200 million, scheduled for shipment in the first seven months of 1966.

EXPORTS OF WHEAT AND FLOUR



Seasonally adjusted at annual rates.

The growth of Canadian exports other than wheat slowed down in 1965 though, as indicated in the chart on the following page, there was a marked improvement in the last quarter of the year. Exports to the United States in 1965 rose at about the same rate as in 1964. However, since total imports into the United States rose much more rapidly in 1965 than in 1964, Canada's share of the U.S. import market failed to increase as it had done in 1964. As noted on page 44, economic growth in some of Canada's major overseas markets slackened in 1965; apart from wheat sales, Canadian exports to overseas markets either increased more slowly than in 1964 or declined slightly. Canada's share of total imports into most of these markets either held steady or fell in 1965 in contrast to 1964 when our share had increased.

CANADIAN EXPORTS EXCLUDING WHEAT AND FLOUR[1]

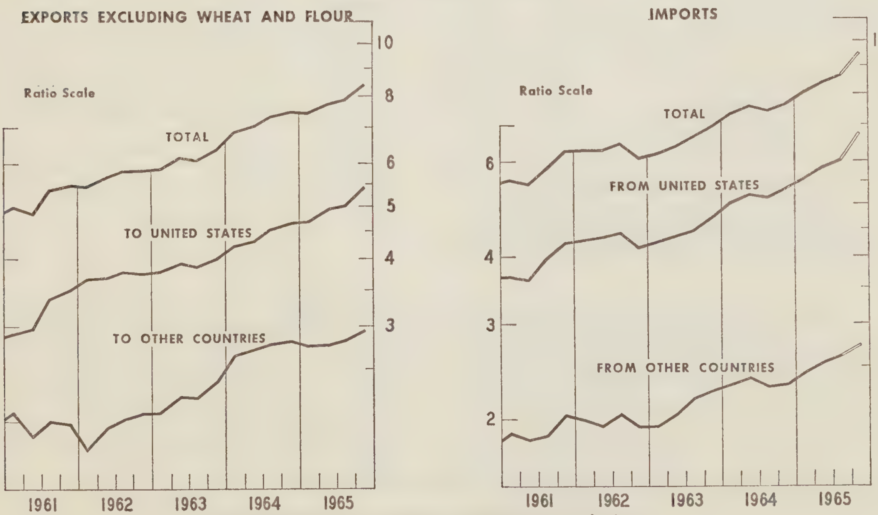
	Value (millions of dollars)		Percentage change from previous year	
	1964	1965	1964	1965(2)
		(11 months)		
To: United States	3,886	4,389	14	13
Britain	941	924	25	−2
Continental Europe	571	649	25	14
Japan	205	199	13	−3
Australia, New Zealand, South Africa	217	234	37	8
All other countries(3)	523	511	17	−2
Total	6,342	6,906	17(4)	9

(1) Trade of Canada basis, excludes re-exports.
(2) Change from first 11 months of 1964 to first 11 months of 1965.
(3) Mainly less-developed countries; also includes Eastern Europe.
(4) Adjusted for balance of payments purpose the increase was 15 per cent.

Most of Canada's major exports of primary resource products rose less rapidly than in 1964 although the increase in base metal exports was still substantial. Canadian producers of some commodities, such as steel and certain base metals, were operating at the limit of their productive capacity and experienced difficulty in meeting fully both export and domestic demand. The growth in exports of manufactured goods other than automobiles and parts slowed down considerably. Following the signing in January 1965 of the

MERCHANDISE TRADE

Quarterly — Billions of Dollars



Trade of Canada basis; seasonally adjusted at annual rates.

Canadian-United States Automotive Agreement, which provided for the removal of tariffs and encouraged an increase in two-way trade in parts and completed automobiles and trucks, exports of these products increased to nearly twice their 1964 level. Even so, the deficit on trade in automobiles and parts widened somewhat further in 1965 as imports continued to rise strongly reflecting in part the high level of Canadian demand.

Total merchandise imports again rose more rapidly than domestic output. Having gone up by nearly 15 per cent in 1964 imports increased by a further 15 per cent in 1965, with a marked upsurge in the fourth quarter. The strength in imports reflected continued strong domestic demand for industrial materials, machinery and other investment goods, automobiles and other consumer durables. Imports of aircraft also rose substantially in 1965. The value of food imports, on the other hand, fell as a result of a sharp drop in the price of sugar. The table below summarizes the changes in imports by end-use through the first nine months of 1965 but does not reflect the sharp increase which occurred in the fourth quarter, details of which are not yet available.

CANADIAN IMPORTS CLASSIFIED BY END-USE(1)

	Value (millions of dollars)				Percentage change from previous year	
	1963	1964	1964 (9 months)	1965 (9 months)	1964	1965(2)
Fuels and lubricants......	529	547	394	438	3	11
Industrial materials.......	1,857	2,079	1,530	1,678	12	10
Producers' equipment.....	1,617	1,896	1,435	1,585	17	10
Construction materials....	203	274	194	228	35	18
Transportation equipment.	177	194	140	216	10	54
Motor vehicles and parts..	698	849	635	778	22	23
Food.....................	712	713	520	479	–	−8
Other consumer goods....	625	718	526	585	15	11
Special items............	138	219	149	201	59	35
Total.................	6,558	7,488	5,522	6,188	14	12

(1) Trade of Canada basis.
(2) Change from first 9 months of 1964 to first 9 months of 1965.

The continuing strong demand for imports coupled with the relatively small increase in total exports resulted in a reduction in the merchandise trade surplus by about $600 million between 1964 and 1965. This followed five consecutive years in which exports had risen more rapidly than imports. However, as the table on the following page shows, if exports of wheat and flour are excluded from the merchandise trade account the improving trend in the balance came to an end in 1963.

MERCHANDISE TRADE[1]

(millions of dollars)

	1963	1964	12 months ending Nov. 1965
Imports........................	6,579	7,540	8,510
Exports........................	7,082	8,240	8,650
Balance.....................	+503	+700	+140
Wheat exports..................	881	1,093	920
Balance excluding wheat exports..	−378	−393	−780

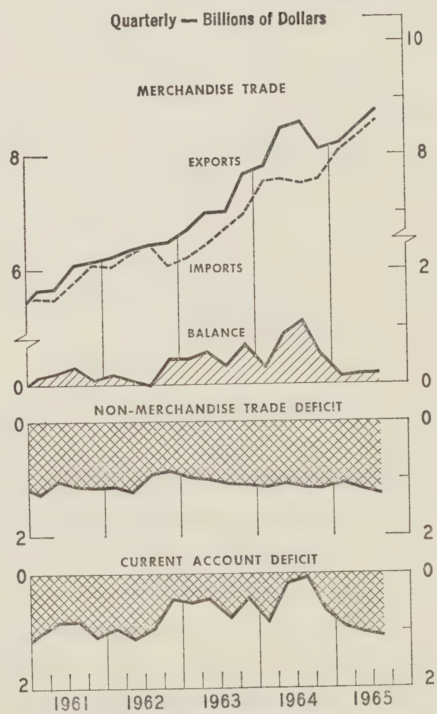
(1) Adjusted to balance of payments basis.

The deficit on non-merchandise transactions in 1965 was about $100 million larger than the $1,133 million recorded in 1964. A substantial increase in net payments of interest and dividends to non-residents, and smaller increases in official aid contributions and in expenditures on freight and shipping were offset only in part by an improvement in the balance of inheritances and migrants' funds. The deficit on travel expenditures was about the same as in 1964.

Canada's total current transactions with other countries resulted in a deficit of more than $1,100 million in 1965 compared with one of $433 million in 1964. The 1965 deficit with the world as a whole was well below the peak levels of the late 1950's but the current account deficit of over $1,900 million with the United States was considerably higher than in any previous year. The surplus with other countries was about one-third below its unusually high 1964 level, but it remained higher than in any other recent year.

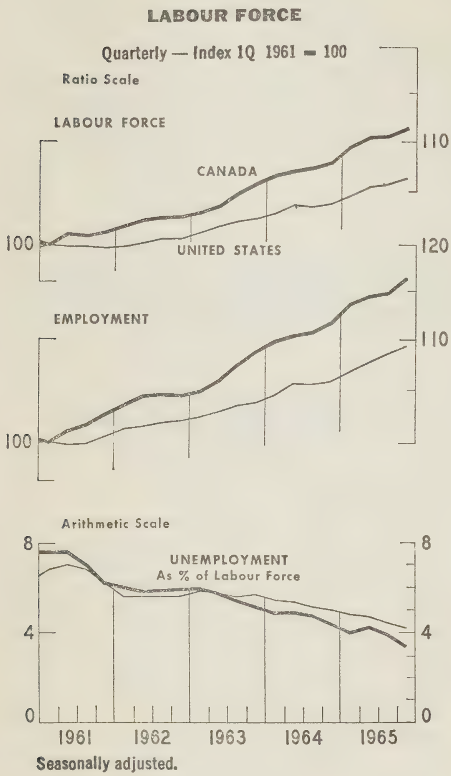
CURRENT ACCOUNT OF THE BALANCE OF PAYMENTS

Quarterly — Billions of Dollars



Balance of payments basis; seasonally adjusted at annual rates.

A feature of the Canadian economic situation which will continue to be of great importance for some time to come is the high rate of growth in the labour force. In 1965 the Canadian labour force increased by 3.0 per cent compared with an increase of 1.9 per cent in the United States. The female labour force continued to rise very strongly, though the increase of 5.3 per cent was slightly lower than in 1964. To an important extent the growing number of women in the work force reflects the trend towards higher rates of labour force participation, particularly by married women. The increase in the male labour force, which is determined more particularly by demographic factors, was 2.1 per cent. This represented a significant acceleration from the 1.7 per cent increase of the previous year and can be attributed mainly to the entry into the labour force of many of those born immediately after the war in the years of high birth rates and to a significant increase in net immigration.



Total employment in Canada rose by 3.8 per cent in 1965 compared with an increase of 2.6 per cent in the United States. Farm employment in Canada, which has been declining for many years, showed a particularly sharp drop of 5.7 per cent in 1965. Non-farm employment rose by 4.8 per cent, one of the largest annual increases on record. A significant part of the increase in employment, particularly among married women and teenagers, appears to have been associated with the increasing opportunities for, and popularity of, part-time work.

Although the movement of the seasonally adjusted unemployment rate in the course of the year was rather uneven, mainly because of the large influx of students into the labour force in June and July, the trend was clearly downward. In the fourth quarter the rate averaged 3.4 per cent. The unemployment rate in

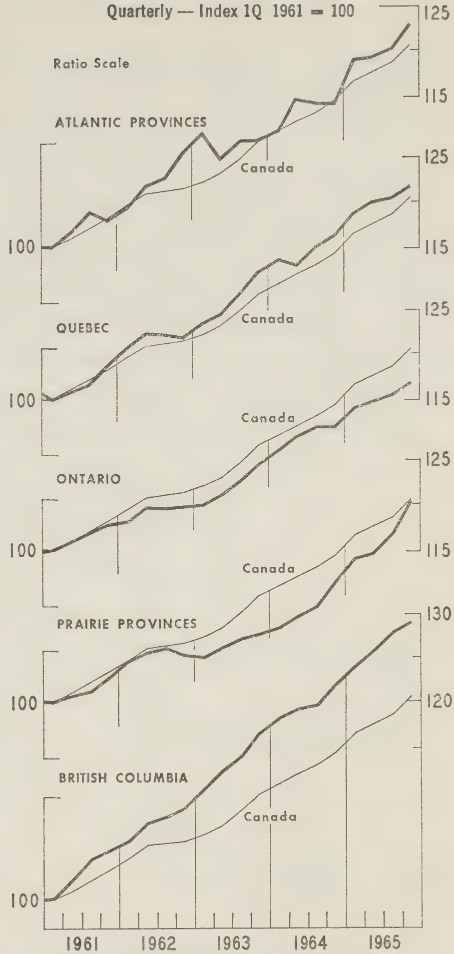
Canada, which was considerably higher than the U.S. rate at the beginning of the expansion and then fluctuated around the U.S. rate for an extended period, has been below the U.S. rate since late 1963. In the last quarter of 1965 the gap was more than ½ of 1 per cent, although the adult male unemployment rate remained slightly higher in Canada.

All the main regions of the country shared in the strong growth of non-farm employment in 1965, with increases of 3½ per cent in Ontario, close to 5 per cent in Quebec, just under 6 per cent in British Columbia and the Atlantic region, and nearly 7 per cent in the Prairies. As the insert diagram shows, the increase in non-farm employment over the period of the expansion as a whole from the first quarter of 1961 to the fourth quarter of 1965 was in excess of the national average in the Atlantic Provinces, Quebec and British Columbia.

As the following table shows, all five regions also shared in the further reduction of unemployment in 1965, although marked regional disparities remain.

NON-FARM EMPLOYMENT BY REGIONS

Quarterly — Index 1Q 1961 = 100



Seasonally adjusted.

REGIONAL UNEMPLOYMENT RATES

(per cent of labour force)

	Atlantic	Quebec	Ontario	Prairies	B.C.	Canada
			Annual averages			
1956	6.0	5.0	2.4	2.2	2.8	3.4
1961	11.2	9.2	5.5	4.6	8.5	7.1
1962	10.7	7.5	4.3	3.9	6.6	5.9
1963	9.5	7.5	3.8	3.7	6.4	5.5
1964	7.8	6.4	3.2	3.1	5.3	4.7
1965	7.4	5.4	2.5	2.5	4.2	3.9
			Seasonally adjusted			
1965–fourth quarter	6.2	5.0	2.1	1.9	3.6	3.4
			Not seasonally adjusted			
1965–low point(1)	3.7	3.4	1.4	1.0	2.8	2.4

(1) September or October.

In the buoyant state of the economy there were larger wage settlements and a continued increase in fringe benefits in 1965. After taking account of salaries, which also rose appreciably during the year, average earnings per employee rose more rapidly in 1965 than in 1964—particularly in construction but also in manufacturing, mining and other commercial activities. As there appears to have been a smaller increase in average output per employee in 1965 than in 1964, wages and salaries per unit of output rose much more sharply in all the main sectors of business activity than in 1964 or in the earlier years of the expansion. The total profits of incorporated and unincorporated businesses per unit of output also apparently continued to increase, though not as strongly as in 1964. The combined effect of the trend of money incomes on the main factors of production was to exert greater upward pressure on prices in 1965. The changes in the main categories of money incomes per unit of output in commercial activities other than agriculture may be seen in the following table.

INCOMES PER UNIT OF OUTPUT:
COMMERCIAL NON-FARM ECONOMY(1)

(percentage change from previous year)

	1962	1963	1964	1965(2)
Wages and salaries per unit of output				
Manufacturing	−0.3	0.6	0.6	2.2
Mining	−4.2	−0.2	−5.3	6.1
Construction	6.7	3.1	1.6	9.9
Other commercial activities	0.2	1.1	2.9	4.8
Total	0.4	1.1	1.7	4.5
Business profits per unit of output	1.7	0.5	3.3	0.4
Wages and salaries plus business profits per unit of output	0.8	0.9	2.1	3.3

(1) Excludes agriculture, government and community services.
(2) Change from first 9 months of 1964 to first 9 months of 1965.

The table is based on the following D.B.S. statistics: Output — "Indexes of Real Domestic Product;" Wages and salaries — "Estimates of Labour Income" (excluding all supplementary labour income and wages and salaries in the sectors listed in footnote (1) above); Business profits — Total corporation profits before taxes plus net income of non-farm unincorporated business as given in the "National Accounts".

The response of prices to the combination of strong demand and rising costs is shown in the following table and in the table on page 13. Even after allowing for the rather special nature of certain of the price increases, for example in some food items, automobile insurance and prepaid medical care, it is evident that prices generally are reflecting the incidence of widespread upward pressures. As the following table also shows, each of the major categories of the Consumer Price Index rose significantly more in Canada than in the United States in 1965.

PRICES

(percentage change from previous fourth quarter)

	Canada				United States
	4 Q'62	4 Q'63	4 Q'64	4 Q'65	4 Q'65
Consumer prices					
Food	3.1	2.6	0.9	4.3	2.9
Goods other than food	0.5	0.8	0.8	1.2	0.7
Shelter	1.9	1.9	2.6	2.6	2.0
Services[1] — automobile insurance	1.7	−0.2	11.6	26.5	3.3
— prepaid medical care	0.2	8.7	8.0	5.6	
— other services[1]	2.3	1.4	3.2	4.8	
Total C.P.I.	1.7	1.6	1.6	2.9	1.8
Total C.P.I. excl. food	1.2	1.3	1.9	2.5	1.6
Total C.P.I. excl. food, automobile insurance, and prepaid medical care	1.2	1.1	1.7	2.0	n.a.
Prices of all goods and services (GNP deflator)	2.2	1.7	2.4	2.9[2]	1.9

(1) Excluding shelter services.
(2) Change from 3Q'64 to 3Q'65.

Monetary and Financial Developments

The pressures on the economy's physical resources which developed in 1965 had their counterpart in financial markets. The pressures arose mainly from a substantial increase in the capital expenditures of private businesses and of provincial and municipal business enterprises, which led to a major increase in their calls on savings. There was a further improvement in the fiscal position of the federal government. In the personal sector there was an increase in the rate of saving, although consumer and mortgage debt continued to rise rapidly. There was a sharp increase in the use of foreign savings.

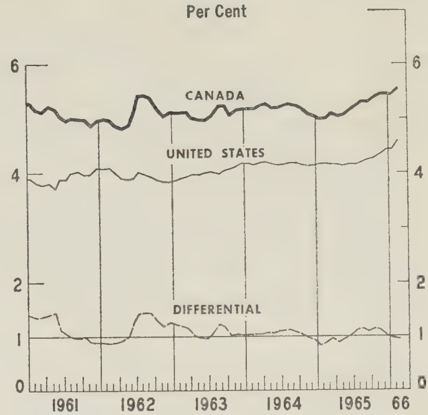
As it became increasingly clear in the course of 1965 that the economic expansion was rapidly taking up the remaining margin of unused physical resources in the economy, conditions in financial markets were permitted to develop in a way which would exert more restraint on domestic spending and attract a sufficient flow of capital to balance our external position. In 1964 there had been little change in the terms on which funds were available in Canada; in 1965 the average yield on long-term Government of Canada bonds rose from 5 per cent in January to 5.4 per cent by December, yields on the bonds of other borrowers rose somewhat more, and prime rates on conventional mortgages increased by ½-¾ per cent. The yield on three-month treasury bills increased by about 75 basis points in the course of the year and other short-term paper rates rose substantially more. While chartered bank loans continued to expand rapidly, a further reduction of the banks' liquidity ratios made it necessary for them as the year progressed to become more selective in considering new credit applications. In the first half of December the chartered banks raised their prime loan rates from 5¾ per cent to 6 per cent.

The pattern of events in the course of 1965 was also influenced by developments relating to our external financial position, particularly the U.S. balance of payments guidelines, and by the repercussions of the default of Atlantic Acceptance in June.

Following the period of heavy Canadian borrowing in the United States in the autumn of 1964, there had been some temporary easing of credit conditions in Canada which continued into the early weeks of 1965. On February 10, 1965 the United States embarked on a new programme designed to improve its balance of payments. Until the details of the programme were developed and a set of guidelines issued there was a good deal of uncertainty in Canada about the

nature and probable impact of the programme. The Canadian bond market weakened as a result of concern that the guidelines might interfere with access to the U.S. market by Canadian borrowers wishing to place new bond issues. The Bank of Canada resisted the downward pressure on bond prices by purchasing Government securities in the market after February 10; the rise in the average yield on long-term Government of Canada bonds during the next month was limited to about 10 basis points. By mid-March U.S. investors had started to reduce their holdings of foreign currency deposits in Canadian banks and of short-term finance company paper and it became evident that the principal impact of the U.S. guidelines would be felt in the short-term market. In the bond market, confidence had reappeared and yields were moving down again.

LONG-TERM
GOVERNMENT BOND YIELD AVERAGES[1]

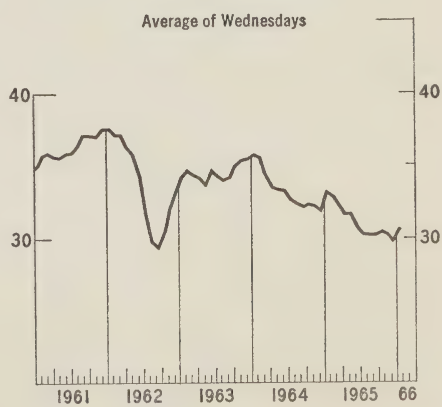


1. Monthly average of Wednesday closing yields on all direct issues due or callable in 10 years or more.

Beginning in April the cash management of the Bank of Canada was conducted in such a way that the continued strong expansion of the chartered banks' loans brought about a further reduction in the ratio of their "more liquid" assets to total assets. Credit conditions generally became less easy. The yield on three-month treasury bills, which had declined during the first quarter of the year, rose by about 40 basis points between the beginning of April and the beginning of June to a level just under 4 per cent. Other short-term paper rates moved up as much. Bond yields also rose in the second quarter: in June the average yield on long-term Government of Canada bonds was 20 basis points higher than in January and the differential over comparable U.S. yields had widened by about the same amount. In June the chartered banks' "more liquid" asset ratio was less than 31 per cent compared to 33 per cent in January 1965 and 36 per cent at the beginning of 1964.

The finance company default on June 14 accelerated the development of less easy credit conditions. Though the

CHARTERED BANK
"MORE LIQUID" ASSETS
As % of Total Assets

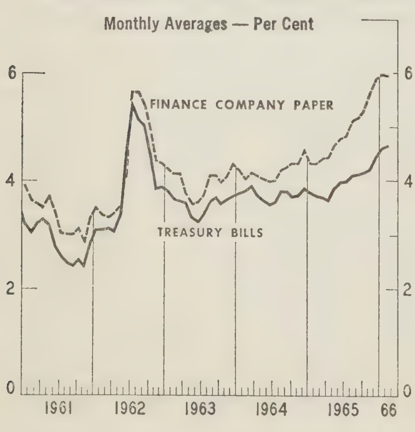


Bank of Canada promptly increased the banking system's cash reserves and took the other action described in the first part of the Report to guard against the possibility than other financial institutions might come under serious liquidity pressure, credit conditions tightened significantly. While the support provided by the central bank and the chartered banks helped to stabilize the situation, the central bank had to continue to take account of the problem in its operations.

During the summer, evidence of strains on the economy continued to accumulate, particularly in the large upward revision of 1965 capital spending indicated by the mid-year survey conducted by the Department of Trade and Commerce. It was also becoming clear that Canada faced a substantial increase in its current account balance of payments deficit. Long-term interest rates rose during the summer, and towards the end of July treasury bill rates also began to move up again. When the sale of wheat to the Soviet Union was announced in August and a shift in market expectations resulted in a tendency for bond prices to rise, the Bank of Canada countered this by selling securities in the market. The inclusion of $100 million of long-term bonds in the federal government refunding issue offered in mid-August operated in the same direction. By November the average yield on long-term Government of Canada bonds was 25 basis points higher than in June and the yield on three-month treasury bills had risen as much. The differential between long-term Government bond yields in Canada and the United States had widened during the summer but U.S. interest rates began to rise in August and the differential held relatively steady through the autumn.

Rates of interest in some other parts of the market increased more sharply. By the end of the year the rates on finance company short-term paper were 1¼ per cent higher than in June and the chartered banks had substantially increased their rates on short-term deposit instruments. Beginning in late summer many mortgage lending institutions cut back their new lending activity from the high rate at which funds were being committed earlier in the year. The demand for mortgage funds remained strong and conventional mortgage rates rose in the second half of the year. In the fourth quarter trust and mortgage loan companies raised the rates on their certificates and debentures sharply.

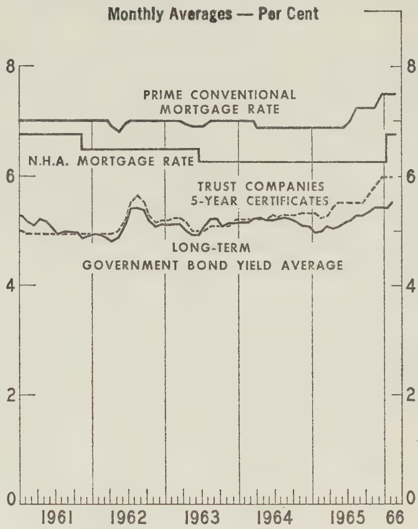
CANADIAN 3 MONTH INTEREST RATES



In view of the extent to which credit conditions were tightening and the rate at which funds were being borrowed in the U.S. market the Bank of Canada

offered some resistance to the rising trend of interest rates. During the autumn the Bank increased its holdings of treasury bills and maintained chartered bank cash at somewhat higher levels on occasions when the market threatened to tighten excessively. After the official request on November 9 that the delivery of issues already negotiated in the United States should be deferred and that new U.S. borrowings should be postponed until 1966, bond prices weakened and the Bank of Canada prevented a sharp upward adjustment of bond yields by providing moderate support. When the Bank Rate was raised by ½ per cent effective December 6 the following statement was issued:

CANADIAN LONG-TERM INTEREST RATES



> "The Bank of Canada announced tonight that the Bank Rate, which had been 4¼ per cent since November, 1964, has been increased to 4¾ per cent effective December 6.
>
> This action followed the announcement of the increase of ½ per cent in the rediscount rates approved by the Federal Reserve Board of the United States.
>
> The Governor, Mr. Louis Rasminsky, stated that the policy of the Bank would continue to be directed to making provision for the over-all credit needs of sound economic growth."

This indication that the increase in the Bank Rate was not intended to mark any major departure from the policy of the Bank as it had been developing helped to stabilize the bond market with little support by the central bank. Increases in market yields were concentrated in the short-term maturity range and by the end of December long-term Government yields were no higher than they had been early in November. Long-term yields were rising in the United States and the differential narrowed by about 15 basis points from mid-November to the end of the year. The arrangement announced on December 5 which ensured that Canadian borrowers would be exempt from the new guideline restricting access to the U.S. market for new long-term issues was an important factor contributing to the stability of Canadian bond prices in this period.

There were some special factors putting upward pressure on short-term interest rates during December. In particular, the supply of funds for investment in short-term paper fell off as a result of the December 15 tax date in the United States and corporate window-dressing for year-end statements. The Bank of Canada eased the banking system's cash reserve position in order to prevent these developments from tightening the short-term market unduly.

CHARTERED BANK ASSETS. The total of the Canadian dollar and net foreign assets of the chartered banks rose by 12 per cent in 1965 compared to 5¼ per cent in 1964. General loans expanded at the same 16 per cent rate as in 1964, and the expansion of the two main components of general loans, namely business loans (14 per cent) and unsecured personal loans (22 per cent), was also in line with experience in 1964. By contrast, loans to the other main groups of borrowers all increased a good deal more rapidly than in 1964. Part of the increase in loans to sales finance companies was an indirect consequence of the finance company default. Heavy municipal borrowing reflected the relatively low level of municipal security issues as well as the financing of projects for which funds will be forthcoming from the Municipal Development and Loan Board. The banks' total Canadian dollar loans rose 20 per cent compared to an increase of 14 per cent in 1964. There was also an increase in foreign currency lending to Canadian residents. During 1965 the banks' holdings of foreign currency securities issued by Canadian borrowers plus their foreign currency loans to residents of Canada rose by $275 million compared to $195 million in 1964.

CHARTERED BANK LOANS

(millions of dollars)

	Dec. 1963	Dec. 1964	Dec. 1965	Percentage changes 1964	1965
Month-End					
Business loans	4,354	4,929	5,627	13.2	14.2
Unsecured personal loans	1,432	1,793	2,186	25.2	21.9
Other personal loans	464	531	615	14.4	15.8
Loans to farmers	635	708	804	11.5	13.6
Loans to institutions	234	262	285	12.0	8.8
Total general loans	7,119	8,222	9,517	15.5	15.8
Average of Wednesdays					
Total general loans	7,086	8,204	9,505	15.8	15.9
Loans to Provinces	44	33	56	−25.0	69.7
Municipalities	304	349	514	14.8	47.3
Grain dealers	186	143	235	−23.1	64.3
Sales finance companies	249	274	470	10.0	71.5
Total	7,869	9,002	10,780	14.4	19.8

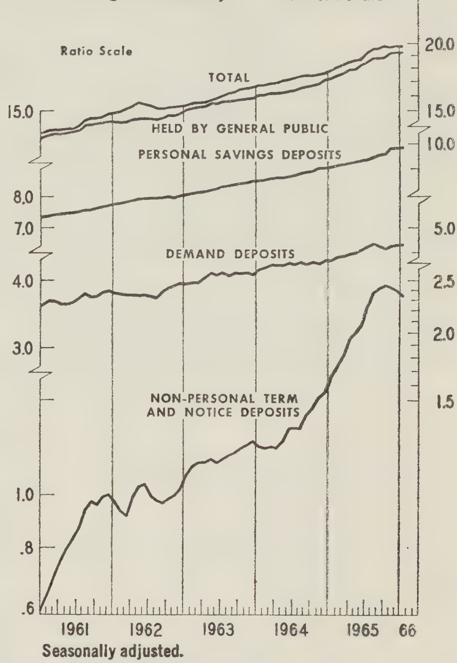
In 1965 as in 1964 the pace of expansion in the banks' loans exceeded the growth rate of their total assets. In December 1965 the banks' holdings of "more liquid" assets were about $250 million higher than a year earlier but the ratio of "more liquid" assets to total assets had declined from 32 per cent to 30 per cent.

CHARTERED BANK DEPOSITS AND OTHER LIQUID CLAIMS HELD BY THE PUBLIC. In December 1965 the total of currency and chartered bank Canadian dollar deposits was 12 per cent higher than a year earlier compared to an increase of 6 per cent in 1964. The amount held by the general public, i.e., exclusive of Government of Canada deposits, increased by 12 per cent compared to 7½ per cent in 1964. The increases in both of these series in 1965 were particularly rapid during the summer at the time of the difficulties created by the finance company default; during the last few months both series have levelled off.

The rate of growth of currency and demand deposits was about the same in the two years. The more rapid expansion of total Canadian dollar deposits in 1965 reflected the fact that the banks' personal savings deposits and more particularly their other interest-bearing term accounts expanded much more rapidly than in 1964. The table below also shows that the amount of foreign currency deposits held with the chartered banks by Canadian residents declined in 1965 after a very rapid increase in 1964. For the total of these and the Canadian dollar deposits, the rate of increase was about the same in the two years.

CURRENCY OUTSIDE BANKS AND CHARTERED BANK DEPOSITS

Average of Wednesdays — Billions of Dollars



Seasonally adjusted.

CURRENCY AND CHARTERED BANK CANADIAN DOLLAR AND FOREIGN CURRENCY DEPOSITS

(percentage change from previous December)

	1964	1965
Currency outside banks and demand deposits........	6.3	6.5
Personal savings deposits..........................	5.9	9.0
Non-personal term and notice deposits..............	23.0	54.1
Sub-total: currency and Canadian dollar deposits held by the public....................	7.3	12.0
Foreign currency deposits of residents..............	65.9	−8.0
Total..	10.1	10.5

The impact of the finance company default on Canadian investors' preferences for various types of financial claims was also an important factor in the rapid growth of the chartered banks' Canadian dollar deposits.

The following table puts the recent trend of currency and bank deposits into a broader framework which includes other types of relatively liquid claims held by the public.

GENERAL PUBLIC HOLDINGS OF CERTAIN FINANCIAL CLAIMS(1)

(millions of dollars)

	Dec. 1963	Dec. 1964	Dec. 1965	Percentage change 1964	Percentage change 1965
Currency and chartered bank demand deposits	6,296	6,693	7,130	6.3	6.5
Chartered bank personal savings deposits	8,357	8,846	9,642	5.9	9.0
Quebec Savings Bank deposits	347	376	402	8.4	6.9
Trust and mortgage loan company demand deposits and certificates	1,079	1,370	1,475	27.0	7.7
Sub-total	16,079	17,285	18,649	7.5	7.9
Chartered Banks					
— non-personal term and notice deposits	1,215	1,494	2,303		
— foreign currency deposits of residents					
— swapped	408	718	549		
— other	390	606	669		
Finance company short-term paper held by residents	525	600	550		
Other commercial paper	241	287	167		
Provincial and municipal short-term paper(2)	230	160	250		
Bankers' acceptances	9	11	150		
Government of Canada					
— Treasury bills	430	332	157		
— Market bonds of maturity under 3 years	1,776	1,402	1,441		
— Canada Savings Bonds	5,133	5,613	5,866		
Provincial savings and parity bonds	470	575	650		
Trust company investment certificates	1,279	1,478	1,930		
Mortgage loan company debentures	845	980	1,060		
Total	29,030	31,541	34,391	8.6	9.0

(1) This table includes relatively small amounts of some items held by non-residents.
(2) Estimated outstanding amount of short-term paper issued by provinces, municipalities and their enterprises.

The first group of claims shown in the table, consisting mainly of accounts which may be transferred by cheque, rose at about the same rate in 1965 as in 1964. There was a significant acceleration in the increase in chartered bank personal savings deposits while the accounts of trust and loan companies grew

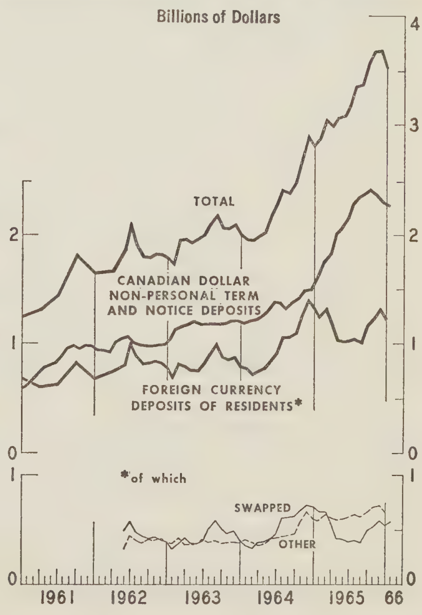
much less rapidly than in 1964. Personal savings deposits fell less than seasonally in November when the annual campaign for the sale of Canada Savings Bonds was held, and it will be noted lower in the table that the net increase in Canada Savings Bonds outstanding was considerably less in 1965 than in 1964.

The rest of the table includes the other liabilities of the chartered banks to Canadian residents and a variety of other interest-bearing claims held by the public. Resident holdings of finance company and other commercial paper both declined during 1965, but there were substantial increases in the amount of short-term paper issued by provinces and municipalities and their business enterprises, and in the amount of bankers' acceptances outstanding. During the summer the banks reduced their acceptance fees and many commercial borrowers who found it difficult to sell their paper or to obtain bank loans chose the alternative of negotiating acceptances. An active market in acceptances has not yet developed and most of them have remained in the hands of investment dealers.

Public holdings of Government of Canada treasury bills continued to decline in 1965 but there was a modest increase in the public's holdings of short-term Government of Canada bonds and a further increase in the amount of provincial savings and parity bonds. The trust companies raised the interest rates offered on their certificates sharply in the second half of the year and succeeded in increasing the outstanding amount very substantially in 1965.

Developments in the banks' swapped deposit business and in their Canadian dollar term deposit business call for particular comment. Swapped deposits are term deposits converted into a foreign currency, usually U.S. dollars, which the bank has undertaken through a forward contract to convert back into Canadian dollars at maturity. The return to the depositor on the investment of Canadian dollars is made up of the yield on his foreign currency deposit and the profit or loss on the exchange swap. Swapped deposits compete directly with other Canadian short-term instruments. By offering attractive rates on swapped deposits the banks built up these balances by $300 million during 1964, partly at the expense of potential growth in their own Canadian dollar short-term deposits on which lower

CHARTERED BANKS: SELECTED DEPOSITS



rates were offered. Canadian residents also increased their other foreign currency deposits with the chartered banks by over $200 million in 1964.

Late in 1964 some chartered banks introduced one-year bearer discount notes and other new Canadian dollar deposit instruments with terms of one year or more. In the first half of 1965 the banks lowered the rates offered on swapped deposits below those on Canadian dollar short-term deposits, in part because the development of a substantial discount on the forward U.S. dollar reduced the return available to the banks on covered short-term foreign investments. These two developments diminished the relative attractiveness of swapped deposits, which declined by about $300 million in the first half of 1965 while the banks' Canadian dollar term deposits were rising very rapidly. Later in the year the banks began to provide flexible short-term Canadian dollar deposit instruments for customers with large blocks of funds, offering yields well in excess of the rates previously available from banks. In the same period, however, there was a sharp increase in the yields available to banks on foreign investments, reflecting in part the exchange profit which resulted from the emergence of a premium on the forward U.S. dollar. As a result the banks offered higher yields on their swapped deposits which began to rise again in September while the Canadian dollar term balances rose less rapidly and then declined during the fourth quarter.

OTHER CAPITAL MARKET DEVELOPMENTS. In addition to the rapid increases in bank loans during 1965 there were unusually large flows of credit in other parts of the financial system. The total amount of consumer credit outstanding increased by about 15 per cent, slightly less than in 1964. The chartered banks continued to increase their share of this business and other lenders also contributed to the growth.

The strong demand for credit was also reflected in the mortgage market. Approvals of residential mortgages by private institutions and Central Mortgage and Housing Corporation were 13 per cent higher in 1965 than in 1964, while approvals of mortgages on non-residential properties were 15 per cent above their 1964 level. The life insurance companies, trust and mortgage loan companies and other private institutions committed mortgage funds at a very rapid rate early in 1965: the value of their approvals in the first half of the year was 32 per cent higher than a year earlier. Later in the year some of the mortgage institutions sharply reduced the rate of their new lending from this unsustainably high rate, although disbursements under earlier commitments led to continued increases in the mortgage portfolios of the institutions. Since the demand for residential and other mortgage financing remained strong, most lenders raised the rates charged for conventional loans by ¼-½ per cent in July and August.

By the end of the year there had been further increases averaging ¼ per cent and many lenders were charging 7½ per cent on prime conventional mortgages.

The maximum interest rate permitted on mortgages guaranteed under the National Housing Act was 6¼ per cent throughout 1965. As higher yields were available on conventional loans, particularly in the second half of the year, private institutions invested less in NHA mortgages than in 1964 while their approvals of conventional mortgages rose by 14 per cent. Central Mortgage and Housing Corporation increased the amount of its direct NHA lending in the second half of the year. On January 10, 1966 the maximum rate was raised to 6¾ per cent in order to attract more private funds into NHA mortgages.

In addition to the increases in mortgage borrowing and bank loans to which reference has been made, private non-financial businesses borrowed heavily from the sales finance companies, and although the amount of short-term commercial paper outstanding at the end of 1965 was $106 million lower than a year earlier there was a more-than-offsetting increase in borrowing through bankers' acceptances. Private non-financial business firms also raised about $200 million more than in 1964 by sales of new bonds and stocks. These new issues included substantial sales to non-residents.

SELECTED ITEMS OF BUSINESS FINANCING(1)

(millions of dollars)

	1963	1964	1965
Increases in			
Bank loans(2)	309	571	655
Sales finance company loans	221	204	210
Commerical paper (excluding grain dealers)	−18	49	−106
Bankers' acceptances	2	2	139
Industrial Development Bank loans	27	31	29
Net new issues of bonds	450	547	841
Net new issues of stocks	223	345	252
Total	1,214	1,749	2,020

(1) Excludes most forms of mortgage borrowing by non-financial businesses, for which comparable information is not available.
(2) Business loans, excluding provincially guaranteed loans to public utilities.

The financial requirements of provincial and municipal governments and their enterprises taken as a whole rose sharply in 1965. The amount raised by these governments and their enterprises by the net sale of bonds was well below the level in 1964, but their bank borrowings increased substantially, particularly in the case of municipalities, and the outstanding amount of their short-term market paper also rose substantially. The total of these borrowings appears to

have fallen short of the aggregate requirements of the governments and their enterprises and there was probably some reduction in their holdings of cash and liquid assets.

The federal government's balance of revenues and expenditures improved by about $220 million in 1965, on a national accounts basis, following an improvement of $620 million from 1963 to 1964. The changes in the Government's accounts since 1963 are shown in the following table.

GOVERNMENT OF CANADA FINANCIAL ACCOUNTS

(millions of dollars)

	Calendar 1963	Calendar 1964	Calendar 1965
Budgetary balance	−633	−153	+ 70
Adjustments from budgetary to National Accounts basis: (plus sign indicates items added to budgetary revenue or deducted from expenditure, minus sign the reverse)			
Government employee pension fund contributions and interest earnings, less pension payments	+292	+310	+345
Unemployment insurance and old age security fund receipts, less disbursements	−150	− 37	+240
Capital assistance to non-defence industry	+ 56	+ 76	+ 80
Increase in corporate tax liabilities, less collections	+ 28	−123	−132
Disbursements of other Government funds and agencies, less receipts under budgetary appropriations	− 25	+ 74	− 66
Reserves and write-offs	+ 85	+119	+ 44
All other adjustments (net)	+ 55	+ 62	− 31
National Accounts balance	−292	+328	+550
Financing: uses (+) and sources (−) of funds			
Funds advanced to Government lending agencies(1)	+150	+326	+544
Funds from sale of Northern Ontario Pipelines	−108	–	–
Funds repaid or lent to International Monetary Fund	+ 87	+264	+ 68
Investment of Columbia River funds in U.S. securities	–	+220	− 33
Change in accrued corporate tax liabilities less collections	+ 28	−123	−132
Funds advanced to Exchange Fund	+ 35	+ 48	+ 81(2)
Increase (−) in direct and guaranteed debt held outside Government accounts	−976	−195	−137
Change in Canadian dollar bank balances	+470	−307	+156
Change in all other assets and liabilities (net)	+ 22	+ 95	+ 3
Total	−292	+328	+550

(1) Central Mortgage and Housing, Export Credits Insurance and Farm Credit Corporations and the Municipal Development and Loan Fund Board.
(2) Includes $33 million advances in connection with redemption of Columbia River securities which was offset by a corresponding reduction in "Investment of Columbia River funds in U.S. securities".

Source: "Canada Gazette", "Monthly Statement of the Government's Financial Operations". Adjustments to National Accounts basis for 1965 are Bank of Canada estimates.

The outstanding amount of Government of Canada direct and guaranteed securities exclusive of Government account holdings increased by $161 million in 1965.* Public holdings of Canada Savings Bonds increased by $253 million while there was a decline of $92 million in the amount of market securities outstanding outside Government accounts. The fact that the Government was able to effect some net pay-off of maturing market issues at the time of refundings was an important factor in the development of the bond market during the year.

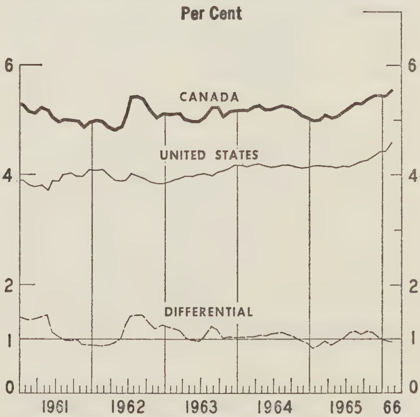
Chartered bank holdings of Government securities changed little on balance in 1965, the Bank of Canada's portfolio increased by $357 million, and there was a net decline of $468 million in the public's holdings of market debt.

FINANCIAL TRANSACTIONS OF CANADIANS WITH NON-RESIDENTS.

The net use of non-resident savings by Canadians increased from $433 million in 1964 to over $1,100 million in 1965. Capital inflows into Canada rose from almost $800 million in 1964 to about $1,300 million in 1965 while official reserves of foreign exchange plus Canada's net creditor position with the International Monetary Fund, which had increased by $363 million in 1964, rose by $157 million in 1965. Details of the main items in the capital account for the first three quarters of 1965 together with estimates of some of the movements in the fourth quarter are given in the table on the following page.

Taken together the major types of long-term capital movements shown in the table gave rise to a net capital inflow of about the same size in 1964 and 1965. Foreign direct investment in Canada was substantially higher than in 1964 but capital outflows resulting from non-resident sales of outstanding Canadian stocks to Canadians and the retirement of called and matured Canadian bonds held by non-residents were also considerably larger. Deliveries of new issues of Canadian bonds sold to non-residents amounted to $1,100 million in both 1964 and 1965. Offerings of new Canadian bond issues in the United States market were exceptionally heavy in the late summer and early autumn of 1964 following the enactment of the U.S. Interest Equalization Tax and the granting of an exemp-

LONG-TERM GOVERNMENT BOND YIELD AVERAGES[1]



1. Monthly average of Wednesday closing yields on all direct issues due or callable in 10 years or more.

* This change differs from that shown in the table as a result of differences in the methods of calculation.

CANADIAN BALANCE OF INTERNATIONAL PAYMENTS

(millions of Canadian dollars)

	1964	1965	1965 1 Q	1965 2 Q	1965 3 Q	1965 4 Q
Current Account Balance	−433	n.a.	−397	−363	6	n.a.
Capital Account Transactions						
Direct investment						
foreign investment in Canada(1)	255	n.a.	70	120	100	n.a.
Canadian investment abroad(1)	−140	n.a.	− 35	−	− 40	n.a.
Canadian stocks						
net transactions	−128	−226	− 77	− 81	− 30	− 38
Canadian bonds						
new issues	1,102	1,105	264	302	297	242
retirements	−306	−366	− 63	−175	− 54	− 74
net trade in outstandings	77	64	3	17	38	6
Foreign securities						
net transactions	− 63	− 74	− 35	− 5	− 22	− 12
Columbia River treaty						
net transactions	54	32	−	−	−	32
Foreign currency position of Canadian banks						
vis-a-vis non-residents net increase (−)	−303	426	219	248	− 23	− 18
Canadian dollar deposits and treasury bills	12	45	64	− 51	− 26	58
Canadian commercial paper	− 11	11	−	7	4	−
Canadian finance company paper	196	−179	− 38	− 7	− 65	− 69
Canadian finance companies' other						
short-term obligations	52	205	25	99	89	− 8
Other long and short-term capital	− 1	n.a.	− 72	−110	− 48	n.a.
Total capital account transactions	796		325	364	220	
Changes in reserves and IMF position						
Official holdings of gold and foreign exchange	86	− 11	−118	− 92	144	55
Net position with IMF	277	168	46	93	82	− 53
Total	363	157	− 72	1	226	2

(1) Exclusive of undistributed earnings.

Note: A positive figure indicates an inflow of capital into Canada, and thus an increase in Canadian liabilities or a decrease in Canadian assets. A negative figure indicates the reverse.

tion for new Canadian security issues. The interest-rate spread between long-term Canadian and U.S. Government bonds narrowed by about 25 basis points between August 1964 and January 1965. In early December 1964 the Canadian authorities suggested to provincial governments that it would be helpful if little use were made of the U.S. market for the time being. The volume of new offerings was reduced until March when the suggestion was withdrawn following the introduction of the U.S. balance of payments measures. After the tightening of the U.S. guidelines in June, when access to other sources of capital was further restricted, the volume of new offerings of Canadian long-term bonds in the U.S. market increased. It remained heavy until mid-November when an official request was made of Canadian borrowers to defer until 1966 the delivery of the proceeds of new issues already negotiated in the United States and to postpone any new U.S. borrowing until then. The carryover of bonds offered in late 1965 for delivery in early 1966 was therefore unusually large.

NEW ISSUES OF CANADIAN BONDS SOLD TO UNITED STATES RESIDENTS

(millions of Canadian dollars)

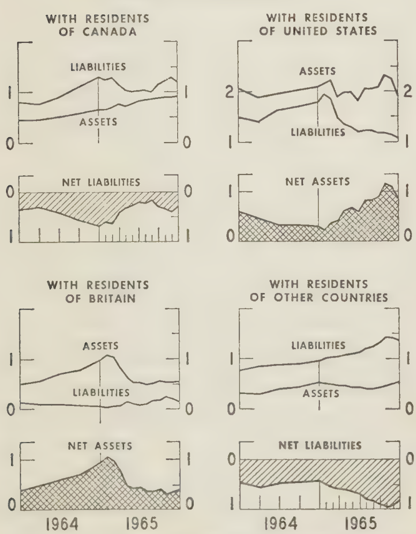
	By date of offering	By date of delivery	Undelivered at end of period
1964			
1 Q	91	125	88
2 Q	238	294	32
3 Q	309	103	238
4 Q	345	532	51
1965			
1 Q	339	255	135
2 Q	265	298	102
3 Q	378	290	190
4 Q	344	232	302

In contrast to the broadly similar pattern of long-term capital flows in 1964 and 1965, there were very substantial changes in the main types of short-term flows. Foreign investors' interest in Canadian finance company paper was reduced by both the U.S. guidelines and the June default. Although the covered yield to foreign investors was relatively high during much of 1965, there was an outflow of $179 million compared to an inflow of $196 million to Canada in 1964. Other short-term borrowings of finance companies provided an inflow of $205 million in 1965. The latter figure includes the effects of the takeover and subsequent financial reorganization of a Canadian finance company by a U.S. firm as well as other short-term transactions between Canadian companies and foreign banks and parent companies.

In 1965 there was a small net capital inflow from transactions in treasury bills and commercial paper and from changes in non-resident holdings of Canadian dollar deposits, compared with almost no net movement in 1964. However, there was a very substantial reversal in flows arising from the foreign currency business of the banks. During 1964 Canadians had built up their swapped deposits and other foreign currency bank balances with Canadian banks, and these funds, together with increased balances deposited by United States residents, were channelled principally into investments in Britain and Continental Europe.

CHARTERED BANKS FOREIGN CURRENCY ASSETS AND LIABILITIES[1]

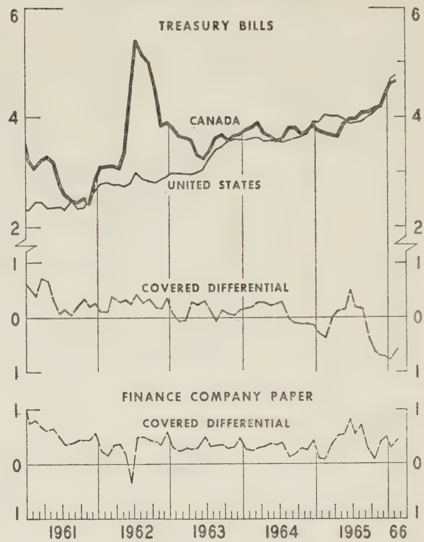
Billions of Canadian Dollars



1. Assets and liabilities carried on the books of head offices and branches in Canada.

SELECTED 3 MONTH INTEREST RATES

Monthly Averages — Per Cent



Following the introduction of the U.S. balance of payments programme in February 1965, the Minister of Finance requested each chartered bank to conduct its foreign currency operations in such a way that the net asset position of head offices and Canadian branches vis-a-vis U.S. residents would not fall below the level at the end of 1964. As U.S. residents withdrew U.S. dollar deposits from Canadian banks in response to the guidelines, the chartered banks met only part of the drain by liquidating investments in the United States; they drew funds from other countries to the extent of $955 million in 1965 by liquidating assets and increasing liabilities. On balance, the foreign cur-

rency operations of the Canadian banks resulted in a net flow of capital into the United States of $529 million and a net inflow into Canada of $426 million in 1965. As the table on page 36 shows this inflow into Canada provided an important part of the financing of the current account deficit in the first half of 1965.

CANADIAN CHARTERED BANKS
HEAD OFFICES AND BRANCHES IN CANADA

NET CHANGES IN FOREIGN CURRENCY POSITION[1]

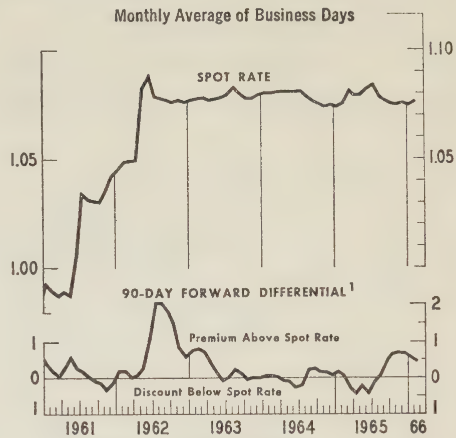
(millions of Canadian dollars)

	1964	1965	1965 1 Q	2 Q	3 Q	4 Q
With non-residents						
U.S. residents						
Assets	40	−208	−215	−83	271	−181
Liabilities	337	−737	−337	−261	−25	−114
Net	−297	529	122	178	296	−67
Other non-residents						
Assets	691	−440	−231	−324	16	99
Liabilities	91	515	110	102	289	14
Net	600	−955	−341	−426	−273	85
Total						
Assets	731	−648	−446	−407	287	−82
Liabilities	428	−222	−227	−159	264	−100
Net claims on non-residents	303	−426	−219	−248	23	18
With Canadian residents						
Assets	198	277	100	71	60	46
Liabilities	532	−107	−167	−136	143	53
Net	−334	383	267	207	−83	−8
Changes in chartered banks' own net position	−31	−43	48	−41	−60	10

(1) Adjusted for variations in exchange rates.

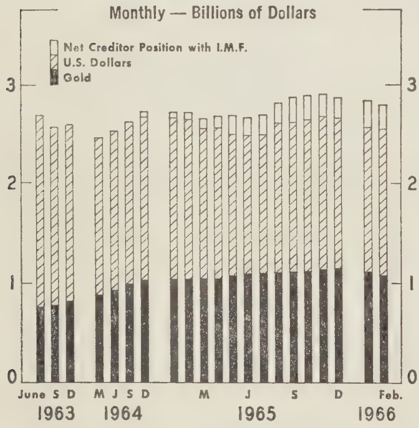
The spot rate for the United States dollar in the Canadian foreign exchange market rose from 107⅜ at the beginning of the year to 108½ in July. It declined following the announcement of the Soviet wheat sale in mid-August and closed the year at 107½. The forward exchange rate for the U.S. dollar in Canada was at a premium from August 1964 to February 1965. The rate moved to a discount in February and to a premium again in late July. From September to December the 90-day forward rate for the U.S. dollar remained at a premium yielding ½-¾ per cent when expressed at annual rates.

U.S. DOLLAR IN CANADIAN FUNDS



1. Expressed as a percent per annum.

OFFICIAL HOLDINGS OF GOLD AND U.S. DOLLARS AND NET CREDITOR POSITION WITH THE I.M.F.



Canada's official holdings of gold and U.S. dollars declined by U.S. $10 million in 1965 while our net creditor position with the IMF increased by U.S. $156 million. Of this latter amount, the equivalent of U.S. $121 million was accounted for by other countries' drawings of the Fund's holdings of Canadian dollars, and the equivalent of U.S. $35 million was accounted for by other countries' drawings of Canadian dollars which the Fund borrowed from Canada under the General Arrangements to Borrow.

BANK OF CANADA OPERATIONS. The Bank of Canada's operations in Government of Canada securities in each month of 1965 are summarized in the table on pages 42 and 43. A net amount of $229 million of Government securities was acquired by the Bank in market transactions, and other transactions led to an additional net increase of $128 million in the Bank's portfolio of Government securities.

The technique of entering into special one-month purchase and resale agreements with money market dealers was used at the end of 1963 and 1964 to offset seasonal currency movements during December and January. In 1965 the Bank of Canada's ordinary security transactions together with variations in the level of the Government's deposit at the Bank provided the necessary offset. On occasion during 1965 the Bank of Canada purchased foreign currency assets from the Exchange Fund on a temporary basis in order to assist in the management of chartered bank cash reserves. In 1965 as in 1964 the Bank of Canada's net earnings were transferred to the Receiver General at various times during the year.

The U.S. $200 million credit facility which was made available by the Bank of Canada to the Bank of England in November 1964 had been drawn on to the extent of U.S. $50 million by the end of 1964. Additional amounts of U.S. $25 million each were drawn in January and April 1965. In May the Bank of England used part of the proceeds of a United Kingdom drawing on the IMF to extinguish its liability to the Bank of Canada. In September 1965, the Bank of Canada along with other central banks entered into new arrangements with the Bank of England to support the improved sentiment towards sterling in the exchange markets. In the case of the Bank of Canada the facility was for an amount of U.S. $75 million; no drawings have been made.

In 1965 the United States drew Canadian dollars in an aggregate amount of $85 million from the IMF. The funds were used to facilitate repayments to the Fund by other countries and the Bank of Canada co-operated in the carrying out of these transactions.

Bank of Canada advances to banks were outstanding on 48 business days during 1965 compared with 15 business days in 1964. The maximum amount outstanding on any one day was $31.7 million and the daily average for the year was $1.77 million compared with $0.02 million in 1964. The Bank of Canada held securities purchased from money market dealers under ordinary resale agreements on 42 business days during the year compared with 49 days in the previous year. The maximum amount outstanding on any one day was $71 million and the daily average for the year was $2.83 million compared with $2.43 million in 1964.

The assets and liabilities of the Bank of Canada at December 31, 1965, together with comparative figures for December 31, 1964, are set forth in the balance sheet at the end of the Report.

BANK OF CANADA NET TRANSACTIONS IN GOVERNMENT SECURITIES IN 1965

(delivered basis — par values in millions of dollars)

	Net purchases from (+) or net sales to (−) investment dealers and banks						
		Bonds(1)					
	Treasury bills	2 & under	2 to 5	5 to 10	Over 10	Sub-total: bills and bonds	Securities under PRA
Jan.	+19	+ 75	− 71	−14	–	+ 9	−100(2)
Feb.	+15	+ 67	+ 3	−46	+ 8	+ 46	–
Mar.	−18	+ 51	+ 4	+ 7	+ 17	+ 61	–
Apr.	−51	+ 82	+ 31	+15	+ 10	+ 87	–
May	+69	+ 8	+ 10	+ 7	+ 12	+106	+ 3
June	−54	+ 2	+ 2	+ 5	+ 37	− 7	− 3
July	−13	− 9	+ 15	–	+ 2	− 5	–
Aug.	− 9	− 4	− 18	–	− 18	− 48	–
Sept.	−21	− 30	− 70	–	+ 1	−119	–
Oct.	+27	+ 2	–	–	–	+ 29	–
Nov.	+ 4	+ 8	–	+ 5	+ 31	+ 48	–
Dec.	+39	− 12	− 7	− 1	+ 5	+ 24	–
Total	+ 7	+239	−101	−22	+105	+229	−100

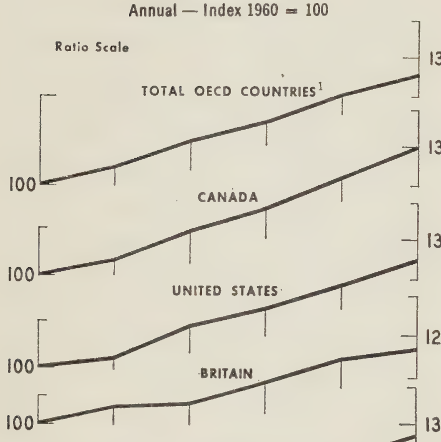
(1) Classified by years to maturity at time of transaction.

(2) Special PRA's: includes $97 million of bonds and $3 million treasury bills.

Net transactions with Government and other accounts								
Purchases (+) of new issues less matured holdings		Net sales (−) to Securities Investment Acct.		Net sales (−) to other Govt. and client accounts		Net change in holdings of Government securities		
bills	bonds	bills	bonds	bills	bonds	bills	bonds	total
− 11	–	–	+ 5	− 46	–	− 41	−102	−143
+ 26	+ 3	–	− 60	+ 6	–	+ 47	− 26	+ 21
+ 37	–	+10	− 30	− 31	−26	− 2	+ 23	+ 21
+ 16	+ 27	–	− 80	+ 12	+10	− 23	+ 96	+ 73
− 42	–	–	+105	− 23	+ 9	+ 6	+152	+158
+ 76	–	–	− 75	− 17	+ 5	+ 4	− 25	− 20
+ 12	+ 44	–	–	− 36	–	− 36	+ 52	+ 16
+ 14	–	–	–	− 16	–	− 10	− 40	− 50
+ 45	+122	–	–	− 22	+ 5	+ 3	+ 29	+ 31
+140	–	–	–	− 15	− 2	+152	–	+153
+ 17	–	–	–	− 20	− 1	–	+ 43	+ 44
+ 5	+ 43	–	–	− 14	− 4	+ 30	+ 24	+ 54
+337	+239	+10	−135	−219	− 3	+131	+226	+357

The External Economic Environment

GROSS NATIONAL PRODUCT
Constant Prices
Annual — Index 1960 = 100



1965 preliminary estimates.

1. Includes countries shown plus Austria, Belgium, Denmark, Greece, Iceland, Ireland, Luxembourg, Netherlands, Norway, Portugal, Spain, Sweden, Switzerland and Turkey.

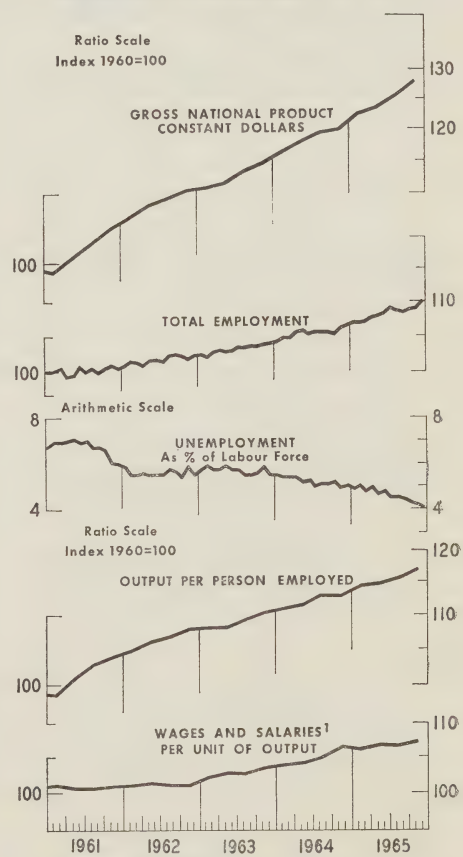
The world trading environment continued on balance to be reasonably favourable to Canada in 1965, despite the slowdown of import demand in two of our important external markets—Britain and Japan. The total output of OECD member countries (which take about 85 per cent of Canada's exports) rose by about 4½ per cent and the value of world trade by some 8-9 per cent. While these increases were somewhat below the exceptionally large gains experienced in 1964, they compare favourably with the average of recent years. In Canada's most important external market, the United States, the economic expansion was even stronger in 1965 than in 1964. Canada's wheat and flour exports received strong support from a shortfall in the Soviet Union's 1965 grain crops and continued strong world-wide demand for wheat.

At the beginning of 1965 most of the overseas industrialized countries were attempting to restrain price and cost pressures. In the course of the year this emphasis in policy was intensified in Germany and also in the Scandinavian countries and in Britain where balance of payments considerations had a major influence

on policy formulation. On the other hand as the year progressed the authorities in Italy and Japan, and to some extent in France as well, felt able to shift the emphasis of policy towards encouraging some acceleration in the growth of demand. In the United States, as unemployment declined the authorities became increasingly concerned that price and cost pressures might develop which could endanger the strong expansion of the past few years. The Government laid stress on its "guideposts" for non-inflationary price and wage behaviour and intervened directly on several occasions to influence price and wage movements. Another important feature of United States policy during 1965 was the issuance of a number of balance of payments guidelines directed towards reducing net capital outflows.

In the United States economic expansion continued through its fifth year at a faster pace than had generally been expected at the beginning of 1965. Total output is now estimated to have risen by 7½ per cent in value and 5½ per cent in volume in 1965, compared with gains of 6¾ per cent and 5 per cent respectively in 1964. Business fixed investment was the most dynamic area of demand, increasing by 15 per cent. Consumer expenditures also advanced strongly, reinforced by tax reductions and increased social security benefit payments. Following two years of virtual stability Federal Government expenditures rose during 1965 as a result of higher defence commitments and expanded welfare programmes. On a national accounts basis the fiscal position weakened at a seasonally adjusted annual rate of $6½ billion from the first to the second half of the year. On the other hand residential construction failed to rise above the previous year's level and export growth was small.

UNITED STATES
MEASURES OF ECONOMIC ACTIVITY



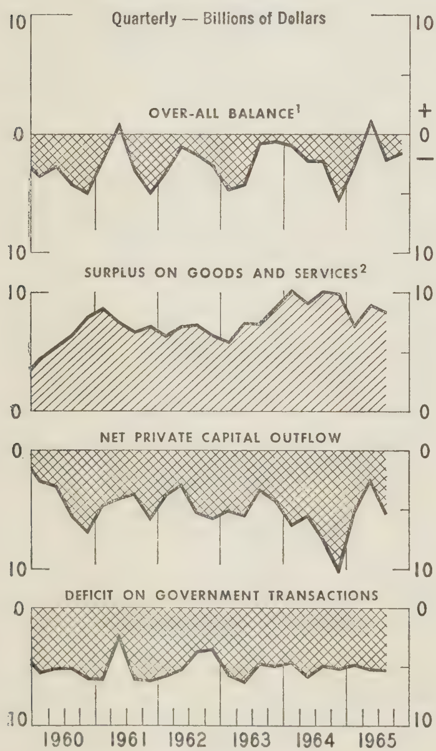
Seasonally adjusted.

1. Includes supplementary labour income and employer contributions for social insurance and to private pension, health and welfare funds.

The margin of unused capacity in the United States was further re-

duced in 1965. This was accompanied by a large increase in imports which went up by 14 per cent compared with 9 per cent in the previous year. As in 1964, employment increased more than the labour force and the unemployment rate fell to an average of 4.2 per cent in the fourth quarter from 5.0 per cent a year earlier. The 5½ per cent increase in output, taken in conjunction with the 2½ per cent rise in employment, implies an increase in output per worker not very different from that experienced in 1964. However, the average number of hours worked went up, and the gain in output per man-hour fell short of both the previous year's performance and the average for the whole expansion. On the other hand wage and salary increases continued to be moderate and unit labour costs in the private sector rose less than in 1964. The higher level of economic activity was accompanied by more upward movement in prices than had been the case in the first four years of the expansion. After increasing at an average annual rate of 1.3 per cent between 1960 and 1964, the GNP price index of all goods and services rose by 1.8 per cent in 1965. The over-all consumer price index in December was 2.0 per cent higher than a year earlier, almost twice the increase experienced during the previous twelve-month period.

UNITED STATES BALANCE OF PAYMENTS



Seasonally adjusted at annual rates.
1. As measured by changes in U.S. official reserve assets and in liquid liabilities to all foreigners.
2. Excludes net military expenditures abroad.

During the course of the year increased attention was given to the risk that aggregate demand might rise at a rate which would exert stronger upward pressure on costs and prices with adverse consequences for the domestic economy and the balance of payments. Credit conditions became tighter in the latter part of the year. There was a rapid growth in bank lending in the course of the year which was associated with a marked increase in public holdings of time and savings deposits at banks and by a reduction in bank holdings of United States Government securities. Commercial bank loans and investments increased by 10 per cent compared with an 8½ per cent increase in 1964. Both the banking

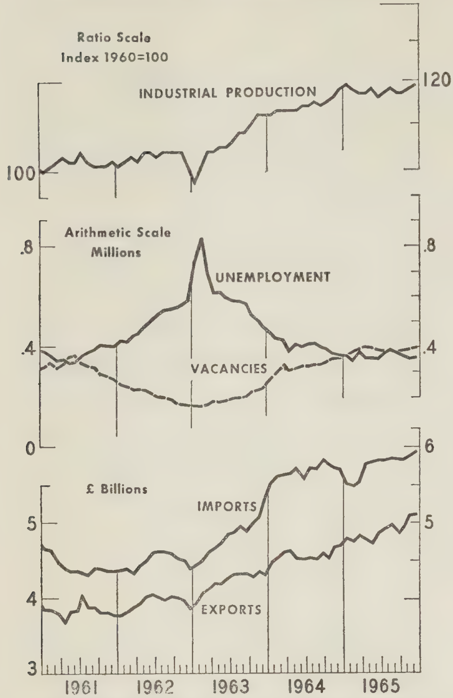
and non-financial business sectors of the economy became less liquid and from July onward interest rates moved progressively higher. By early 1966 interest rates generally had risen to the highest levels for many years. To help moderate the growth in final demand and to meet rising Government expenditures, the President in his 1966 budget message asked Congress to approve tax changes which would accelerate tax payments by corporations and individuals, rescind the recent reduction in excise taxes on automobiles and provide for new charges on the users of transportation facilities.

As the diagram on the preceding page shows, the United States balance of payments position improved sharply immediately after the announcement of the first guidelines in February, but some of the improvement was temporary and the deficit widened again in the second half of the year. For the year as a whole the over-all deficit was about $1.3 billion,* compared with $2.8 billion in 1964. The merchandise trade balance became less favourable, moving from a surplus of $6.7 billion in 1964 to a surplus of $4.8 billion in 1965. Direct investment outflows increased in 1965, particularly in the first half of the year, but the outflow of other capital was greatly reduced. Modifications of the guidelines made early in December were aimed at eliminating the deficit in the over-all payments position in 1966.

Economic developments in Britain during 1965 continued to be dominated by the need to correct the severe balance of payments deficit which had emerged in 1964 and which led to very heavy losses of reserves. The initial steps taken to deal with the situation late in 1964 were reinforced in the April budget, and late in July further measures were taken to restrain the growth of domestic demand, restore equilibrium in the balance of payments and re-establish confidence in sterling. While investment outlays and some other elements of demand, particularly expenditures on consumer durables, were dampened, the easing of pressure on available resources appears to have been modest so far. The labour market remained very tight throughout the year and overtime work continued at a high level. There was a further upward drift in prices. Average weekly earnings in manufacturing rose by more than 8 per cent in 1965 while productivity gains appear to have been slight. The Prices and Incomes Board which was established during the year undertook a number of reviews of proposed increases in both prices and wages and towards year-end issued its first reports. In October the Government announced plans to introduce legislation to strengthen

* As measured by changes in United States official reserve assets and in liquid liabilities to *all foreigners*. (As measured by changes in United States official reserve assets and in liquid and certain non-liquid liabilities to foreign official agencies the deficit was $1.4 billion in 1965 and $1.25 billion in 1964.)

BRITAIN
MEASURES OF ECONOMIC ACTIVITY



Seasonally adjusted (Imports and Exports 3-month moving average at annual rates).

its prices and incomes policy by providing a statutory delaying and reviewing mechanism. Under this legislation price and wage increases could be postponed until a review was conducted by the Prices and Incomes Board.

Britain's payments position strengthened in the course of the year as the result of improved export performance and the reversal of short-term capital outflows consequent upon the re-establishment of confidence in sterling. Exports rose by 7 per cent in 1965 while imports, under the continued restraining influence of import surcharges, went up very little. Non-merchandise earnings were adversely affected by higher interest payments abroad and by the increase in royalty payments to oil-producing countries. Restrictions placed on long-term capital transactions contributed to some improvement on capital account.

Britain's reserves fell very sharply in late 1964 and early 1965 and were maintained only by substantial external official borrowings. Largely to repay temporary financing from a number of central banks Britain drew the equivalent of U.S. $1,000 million from the IMF in December 1964 and a further $1,400 million in May 1965. Through late spring and most of the summer the position of sterling in the exchange market remained uncertain and, as previously noted, further restraints were introduced late in July. Sterling strengthened in September as adverse speculation subsided and some short positions were covered. On September 10, 1965 the Bank of England announced that new arrangements had been made with ten central banks, including the Bank of Canada, to support the improved sentiment towards sterling in the exchange markets. Since September reserves have risen and there has been a sizeable repayment of official short-term liabilities.

The pattern of economic developments in Continental Europe was mixed in 1965. Germany, with a very strong over-all demand situation in conditions

of full capacity utilization and an extremely tight labour market, experienced a somewhat slower rise in total output, further significant increases in prices and costs and a rise of 20 per cent in imports. In France, where price and to a lesser extent wage increases were moderated by the maintenance of the 1963 stabilization programme, there was a modest recovery in demand and output. While the authorities refrained from adopting a vigorous expansionary policy on the ground that this might lead to a revival of the "inflation psychology" which accompanied earlier periods of more rapid growth, they nevertheless took some selective measures to reactivate the economy and to improve the conditions for financing investment. In 1965 Italy experienced a gradual recovery in output and employment; exports continued to rise strongly, expenditures on public works increased and consumer outlays revived somewhat. Measures also were taken to encourage private investment.

Economic activity in most other Western European countries continued to expand in 1965, though less rapidly than in 1964. In nearly all these countries, economic policy was directed towards restraining domestic inflationary pressures.

In Japan industrial output increased only marginally during the year despite the relaxation of the measures taken in 1964 to deal with the sharp deterioration in the balance of payments; a strongly expansionary fiscal policy was adopted late in 1965.

Australia, New Zealand and South Africa continued to experience strong domestic expansion in 1965 and adopted measures of restraint as price and cost pressures mounted and reserves fell.

The economic performance of the primary-producing countries, whose domestic level of activity is heavily dependent on export earnings of one or a few primary commodities, varied widely in 1965. Those exporting petroleum and non-ferrous metals did relatively well as demand for their products remained buoyant and export prices of metals continued to rise; many of these countries added to their exchange reserves. Countries relying mainly on the export of tropical agricultural products, on the other hand, fared less well although their external positions appear to have improved somewhat towards year-end with the firming of prices for cocoa, coffee and to a lesser extent sugar. Among the countries most adversely affected by developments in commodity markets were India and Pakistan whose external positions remained extremely difficult throughout the year. The major countries of Latin America had on balance a reasonably satisfactory year in external trade. Aided by further measures under the Government's stabilization programme, there was a marked recovery in Brazil's international trade and reserve position during 1965.

CHANGES IN COMMODITY EXPORTS AND IMPORTS

(percentage change from previous year)

	1964		1965[1]	
	Exports	Imports	Exports	Imports
United States	14	9	4	14
Canada	16	15	6	15
Britain	4	15	7	1
France	11	15	12	3
Germany	11	12	11	20
Italy	18	−5	21	−1
Japan	23	16	28	6

(1) Preliminary estimates.

The differing degrees of demand strength in the main industrial countries were strikingly reflected in the development of current account balance of payments surpluses and deficits. In countries where the pace of expansion had slackened and the pressure of domestic demand had eased, substantial trade surpluses developed, reinforced in some cases by strengthened invisible earnings. Japan experienced a favourable swing on current account estimated at more than U.S. $1,000 million which moved her into substantial surplus, while Italy's position improved by an estimated $800 million. France also moved into surplus in 1965, the favourable swing amounting to somewhat more than $500 million, while Britain's 1964 current account deficit of $1,200 million was reduced by over $600 million. On the other hand, Germany moved into a substantial deficit position as her current account deteriorated by about $1,700 million; the United States current account surplus declined by approximately $1,500 million and Canada's current account deficit increased by about U.S. $650 million.

For most of the countries concerned the impact on reserves of these wide swings in current account transactions appears to have been largely offset by capital movements and IMF transactions. Some detail of changes during 1965 in the official reserve assets of IMF member countries (plus Switzerland) are summarized in the table on the following page.

The $1,222 million decline in the United States holdings of reserve assets financed the bulk of its deficit of just under $1,400 million on an official transactions basis. The official holdings of United States dollars of Continental European countries declined substantially in the course of 1965 but there was a small net increase in the official holdings of IMF member countries taken as a group. The increase in Britain's gold and foreign exchange reserves in 1965 was facilitated by a drawing of the equivalent of U.S. $1,400 million in May from the IMF. This brought Britain's total indebtedness to the Fund to about $2,300

million. The Continental European countries' increase in reserve assets was more than accounted for by the rise in their reserve positions in the Fund. The sharp fall in their holdings of foreign exchange (largely United States dollars) was accompanied by an almost equal increase in their holdings of gold.

CHANGES IN THE MAIN COMPONENTS OF OFFICIAL RESERVE ASSETS

(change from previous year-end in millions of U.S. dollars)

<table>
<tr><th></th><th>1964</th><th colspan="4">1965</th></tr>
<tr><th></th><th>Total</th><th>Total</th><th>Gold</th><th>Foreign exchange</th><th>IMF reserve position(1)</th></tr>
<tr><td>United States</td><td>−171</td><td>−1,222</td><td>−1,406(2)</td><td>349</td><td>−165</td></tr>
<tr><td>Canada</td><td>279</td><td>145</td><td>125</td><td>−135</td><td>155</td></tr>
<tr><td>Continental Europe(3)</td><td>3,031</td><td>929</td><td>2,310</td><td>−2,529</td><td>1,148</td></tr>
<tr><td>Belgium</td><td>252</td><td>112</td><td>107</td><td>−103</td><td>108</td></tr>
<tr><td>France</td><td>816</td><td>619</td><td>977</td><td>−623</td><td>265</td></tr>
<tr><td>Germany</td><td>232</td><td>−453</td><td>162</td><td>−778</td><td>163</td></tr>
<tr><td>Italy</td><td>418</td><td>590</td><td>297</td><td>−110</td><td>403</td></tr>
<tr><td>Netherlands</td><td>247</td><td>67</td><td>68</td><td>−94</td><td>93</td></tr>
<tr><td>Spain</td><td>367</td><td>−105</td><td>194</td><td>−333</td><td>34</td></tr>
<tr><td>Sweden</td><td>206</td><td>7</td><td>13</td><td>−61</td><td>55</td></tr>
<tr><td>Switzerland</td><td>45</td><td>125</td><td>317</td><td>−192</td><td>–</td></tr>
<tr><td>Other</td><td>448</td><td>−33</td><td>175</td><td>−235</td><td>27</td></tr>
<tr><td>Britain</td><td>−831</td><td>688</td><td colspan="2">688</td><td>–(4)</td></tr>
<tr><td>Japan</td><td>−39</td><td>133</td><td colspan="2">98</td><td>35</td></tr>
<tr><td>Other IMF members</td><td>126</td><td>425(5)</td><td colspan="2">375(5)</td><td>48</td></tr>
<tr><td>Total of above countries</td><td>2,395</td><td>1,100(5)</td><td colspan="2">−100(5)</td><td>1,221</td></tr>
</table>

(1) The figures in this column represent the amount which members of the Fund are entitled to draw under their "gold tranche position" and as a result of loans made to the Fund under the General Arrangements to Borrow.
(2) Excludes the effect of $259 million gold payment to the IMF in connection with the forthcoming increase in quota.
(3) Includes Switzerland which is not an IMF member.
(4) Britain has had no reserve position in the Fund since December 1964.
(5) Rounded estimates.

This table is based on data from "International Financial Statistics" published by the IMF. The figures for December 31, 1965 are in some cases still preliminary.

Between 1961 and 1964 the official reserve assets of IMF members taken as a group rose at an average annual rate of about U.S. $2,100 million. Some 60 per cent of this increase was in foreign exchange, almost entirely United States dollars; approximately 30 per cent came from net additions to monetary gold stocks and the balance was in the form of larger reserve positions in the IMF.

In 1965 Fund member countries' total reserve assets rose by an estimated U.S. $1,100 million or about one-half the average increase of recent years. As noted previously there was only a small net increase in total official holdings of United States dollars, and official holdings of sterling appear to have declined somewhat. There appears to have been very little net growth in monetary gold stocks (including those of international institutions) despite the maintenance of normal levels of world gold production and continued gold sales by the Soviet Union at about the average rate of recent years. The growth in reserve assets in 1965 was thus more than accounted for by the increase in reserve positions in the IMF.

In 1965 the IMF provided financial assistance amounting to the equivalent of U.S. $2,434 million to member countries experiencing balance of payments difficulties. This was higher than the 1964 level of $1,950 million and only slightly below the record of $2,479 million provided in 1961. The largest single request for financial assistance was made by Britain; it amounted to $1,400 million of which the equivalent of U.S. $107.5 million was provided in Canadian dollars. In connection with the British drawing, the Fund sold the equivalent of $400 million in gold (including U.S. $27.5 million to Canada) to replenish its holdings of various currencies and borrowed the equivalent of $525 million from participants in the General Arrangements to Borrow (including U.S. $35 million from Canada). This was the second occasion on which the General Arrangements to Borrow had been utilized, the first being in December 1964 at the time of the earlier British drawing. Of the total drawings made on the Fund during the past year, approximately half the amount was in Italian lire, deutsche mark or French francs; Canadian and United States dollars each accounted for 12 per cent of the currencies used; and the remaining 25 per cent was in nine other currencies, including Australian pounds and Mexican pesos which were used for the first time in 1965. In October 1965 the Executive Directors approved a four-year renewal of the General Arrangements to Borrow. Under these arrangements ten industrial members of the Fund, including Canada, have agreed to make available to the Fund supplementary financial resources up to the equivalent of U.S. $6,000 million if needed to deal with disturbances in the international financial system.

The developments in world reserves during 1965 provide a good illustration of the concern which has underlain the growing interest of recent years in possible improvements in the international monetary system. In reports made in 1964 by the International Monetary Fund and by the Ministers and Governors of the Group of Ten, both groups concluded that, while there was no immediate danger of a general shortage of international liquidity, there were reasons to believe that the supply of gold and foreign exchange reserves would be inadequate in the longer run to meet the liquidity needs of an expanding world economy. The

continuance of large additions to foreign exchange assets stemming from deficits of the reserve currency countries was no longer regarded as compatible with continued strength of the reserve currencies, and the year-to-year increases in official gold holdings were too uncertain, and in any event too small, to rely on. Both reports therefore indicated that new solutions should be sought.

The Group of Ten set up a committee to examine the technical aspects of the creation of reserve assets, and the report of this group was published in August 1965. In September the Ministers and Governors of the Group of Ten reviewed the situation and decided to undertake "contingency planning" so as to ensure that the future reserve needs of the world would be adequately met. They instructed their deputies to examine and report in the spring of 1966 on "what basis of agreement can be reached on improvements needed in the international monetary system, including arrangements for the future creation of reserve assets, as and when needed, so as to permit adequate provision for the reserve needs of the world economy". They also expressed the hope that Working Party 3 of the Organization for Economic Co-operation and Development, which had earlier been invited by the Group of Ten to carry out a review of the means best suited for achieving a smooth and efficient adjustment over time of countries' payments imbalances, would be able to report in the spring of 1966. Officers of the Bank of Canada, along with those of the Department of Finance, are currently participating in the work of both of these groups.

BANK OF CANADA STATEMENT OF INCOME AND EXPENSES

(thousands of dollars)

	1965	1964
Income		
On investments	$154,806	$140,126
All other income	721	354
Total income	$155,527	$140,480
Operating Expenses		
Salaries(1)	$ 4,435	$ 4,142
Contributions to pension and insurance funds	383	365
Other staff expenses(2)	218	208
Directors' fees	22	23
Auditors' fees and expenses	74	75
Taxes (inc. municipal and business)	1,036	904
RCMP guards and electric protection	133	128
Insurance	58	100
Bank notes — production and shipment	3,893	3,895
Premises and equipment (net)	510	509
Stationery and printing	185	180
Publications(3)	64	69
Postage and express	202	151
Telephones and telegrams	168	163
Travel and transfer expense	175	154
Interest paid on unclaimed balances	51	63
All other expenses	146	173
Total operating expenses	$ 11,753	$ 11,302
Depreciation on Buildings and Equipment	668	941
Net Income Paid to Receiver General of Canada	143,106	128,237
	$155,527	$140,480

(1) The number of staff averaged 912 in 1965 and 896 in 1964.
(2) Includes overtime pay, medical services and cafeteria expense.
(3) Printing of "Statistical Summary" and "Annual Report".

ASSETS

	1965	1964
Foreign exchange		
Pounds sterling and U.S.A. dollars	$ 28,021,133	$ 97,345,863
Other currencies	242,669	237,058
	28,263,802	97,582,921
Cheques on other banks	158,100,628	190,553,152
Accrued interest on investments	40,135,130	37,135,600
Investments — at amortized values		
Treasury bills of Canada	608,101,218	478,687,089
Other securities issued or guaranteed by Canada maturing within two years	477,714,658	349,198,716
Other securities issued or guaranteed by Canada not maturing within two years	2,330,806,758	2,236,452,654
Debentures issued by Industrial Development Bank*	200,677,869	176,500,390
Other securities — U.S.A. Government	13,989,362	13,447,904
	3,631,289,865	3,254,286,753
Industrial Development Bank		
Total issued share capital at cost*	39,000,000	36,000,000
Bank premises		
Land, buildings and equipment Cost less accumulated depreciation	16,296,634	13,223,342
Net balance of Government of Canada collections and payments in process of settlement	41,532,683	10,865,572
Other assets	1,148,857	2,203,118
	$3,955,767,599	$3,641,850,458

*The audited financial statements of the Industrial Development Bank as at September 30, 1965 were issued to the public on December 1, 1965.

L. RASMINSKY, Governor
Ottawa, January 31, 1966.

A. J. NORTON, Chief Accountant

AS AT DECEMBER 31, 1965
(with comparative figures as at December 31, 1964)

LIABILITIES

	1965	1964
Capital paid up	$ 5,000,000	$ 5,000,000
Rest fund	25,000,000	25,000,000
Notes in circulation	2,535,650,110 23	2,380,559,300
Deposits		
Government of Canada	116,230,181	68,912,508
Chartered banks	1,034,239,537	882,106,056
Other	34,539,477	35,632,245
	1,185,009,195	986,650,809
Liabilities payable in pounds sterling and U.S.A. dollars		
To Government of Canada	24,027,229	38,446,788
To others	6,739,614	6,420,049
	30,766,843	44,866,837
Bank of Canada cheques outstanding	172,387,782	197,914,086
Other liabilities	1,953,669	1,859,426
	$3,955,767,599	$3,641,850,458

Auditors' Report • We have examined the statement of assets and liabilities of the Bank of Canada as at December 31, 1965. Our examination included a general review of the accounting procedures and such tests of accounting records and other supporting evidence as we considered necessary in the circumstances. In our opinion, the accompanying statement of assets and liabilities presents fairly the financial position of the Bank as at December 31, 1965.

T. A. M. HUTCHISON, F.C.A.
of Peat, Marwick, Mitchell & Co.

H. MARCEL CARON, C.A.
of Clarkson, Gordon & Cie.

Board of Directors

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N. H. DeBlois	*CHARLOTTETOWN, P.E.I.*
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G. K. BOUEY, *Adviser*
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E. METCALFE, *Auditor*

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C. H. RICHARDSON, *Deputy Secretary*
G. HAMILTON, *Deputy Secretary*
A. J. BAWDEN, *Deputy Secretary*
R. F. ARCHAMBAULT, *Administrative Assistant*
S. V. SUGGETT, *Special Assistant*
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MISS M. K. ROWLAND, *Personnel Officer*
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*S. J. HANDFIELD-JONES, *Assistant Chief*
G. S. WATTS, *Special Assistant*
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W. A. MCKAY, *Research Officer*
T. I. NORTON, *Research Officer*
G. R. POST, *Research Officer*
MISS E. M. WHYTE, *Research Officer*
J. N. R. WILSON, *Research Officer*
L. E. BARCLAY, *Industrial Research Assistant*
MISS H. COSTELLO, *Librarian*

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A. CLARK, *Deputy Chief*
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J. M. ANDREWS, *Assistant Chief*
D. G. M. BENNETT, *Securities Officer*
J. A. J. BUSSIÈRES, *Securities Officer*
R. C. PAGE, *Securities Officer*
J. T. BAXTER, *Toronto Representative*
T. G. BOLAND, *Montreal Representative*
A. W. NOBLE, *Associate Toronto Representative*

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P. WATT, *Deputy Chief*
A. C. LORD, *Assistant Chief*

* On leave of absence as an Executive Director of the International Monetary Fund.

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MONTREAL	J. E. R. ROCHEFORT, *Agent* R. MARCOTTE, *Assistant Agent*
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BANK OF CANADA

ANNUAL REPORT OF THE GOVERNOR TO THE MINISTER OF FINANCE

AND STATEMENT OF ACCOUNTS

FOR THE YEAR 1966

BANK OF CANADA *Ottawa 4*

February 28, 1967.

The Hon. Mitchell Sharp, P.C.,
Minister of Finance,
Ottawa, Ontario.

Dear Sir,

In accordance with the provisions of the Bank of Canada Act I am transmitting herewith my report for the year 1966 and a statement of the Bank's accounts for this period which is signed and certified in the manner prescribed in the by-laws of the Bank.

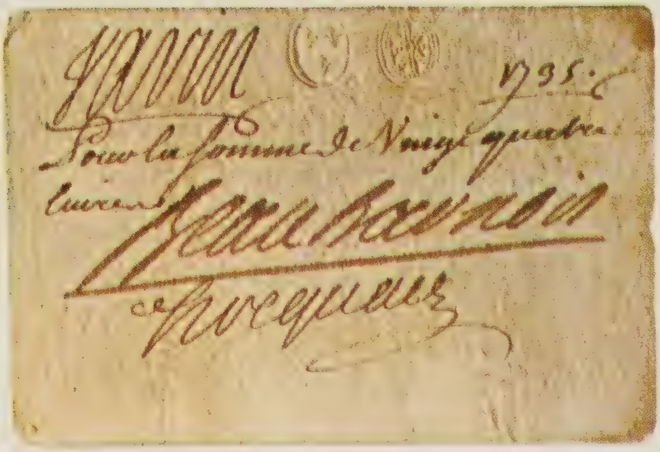
To mark the Centenary of Confederation, I have included in this report a special section presenting coloured photographs of some of the different types of pre-Confederation currency that the Bank has in its numismatic collection.

Yours very truly,

L. Rasminsky

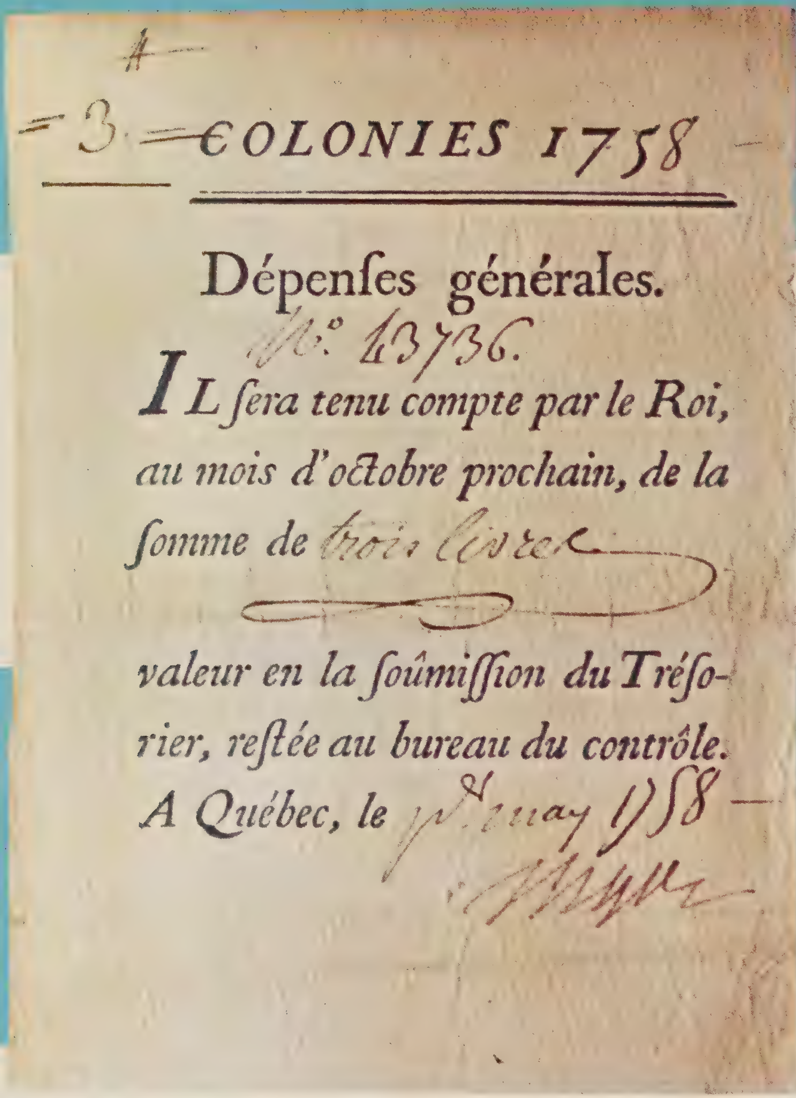
Governor

PRE-CONFEDERATION CURRENCY IN CANADA



As we celebrate the centenary of Confederation it is interesting to recall that the beginning of Canada's currency predated Confederation by nearly two hundred years. On this and on the following pages examples of this early currency are illustrated. They have been selected from the Bank of Canada's numismatic collection.

The card money shown on this page has a dramatic history. In the early days of New France it was the practice to send out a supply of coins on the first ship in the spring to be used in paying the troops and to purchase furs and other raw products. When the supply ship returned to France in the fall it took with it most of the coins to pay taxes and purchase manufactured goods for the colony. This resulted in a scarcity of coins every winter and caused considerable inconvenience. Finally, in 1685 the Intendant, Jacques de Meulles, decided to introduce an emergency issue of paper money. As there were no printing presses and no supply of suitable paper available the notes were handwritten on the backs of playing cards. At the end of the year the notes were redeemed in full. In subsequent years further issues were made. The first five issues were made on playing cards. Their retention after the redemption date was punishable by death and no specimens of this playing card currency have survived. Later issues were made on plain white cardboard and a few of these can be found today in museum collections. The one illustrated here is on plain white cardboard and was issued in 1735.



A —

= 3 = COLONIES 1758

Dépenſes générales.

N°. 13736.

IL ſera tenu compte par le Roi, au mois d'octobre prochain, de la ſomme de trois livres

valeur en la ſoûmiſſion du Tréſorier, reſtée au bureau du contrôle.

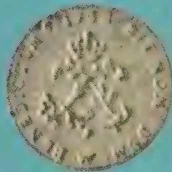
A Québec, le 1er may 1758 —

Card money was supplemented by "ordonnances" or treasury notes issued by the Governor at Quebec. After the Treaty of Paris, in 1763 the outstanding issues of card money and ordonnances were not redeemed. This created a distrust of paper money which lasted for many years.

15 sols
1670

5 sols
1670

9 deniers
1721



billon marque
1744

For over 60 years after the founding of Quebec the inhabitants of New France used ordinary French coins. In 1670 Louis XIV issued the first coins specifically designed for use in Canada. These were silver coins in the denominations of 5 sols and 15 sols. In 1721 copper coins were produced for colonial use and in 1738 small coins made of billon (an alloy of copper and silver) were introduced into French Canada.

The War of 1812-14 was financed by the issue of Army Bills from the headquarters of the British Army at Quebec. At the end of the war these Bills were redeemed in full. This restored trust in paper money and paved the way for the first Canadian banks which appeared on the scene a few years later.

City Bank
penny, 1837

Bank of Montreal
½ penny, 1844

Quebec Bank
penny, 1852

Bank of Upper Canada
½ penny, 1857

From 1763 to 1867 almost nothing was done to provide an official coinage for the British Colonies in North America which now make up Canada. In the first half of the 19th century coins of small denomination were in very short supply and several banks were granted authority to issue penny and halfpenny tokens. These were the Bank of Montreal, The Quebec Bank, The City Bank and La Banque du Peuple in Lower Canada and the Bank of Upper Canada in what is now Ontario.

J. Shaw & Co.
Quebec City

Lesslie & Sons
2 pence, 1822

H. Gagnon & Cie
St. Roch, Que.

T. S. Brown & Co.
Montreal, Que.

A number of merchants in Upper and Lower Canada also issued tokens to increase the supply of small change. Their tokens were frequently lighter in weight than the bank tokens. Most of the merchants' tokens were for a penny or a halfpenny but one firm, Lesslie & Sons, issued a large two penny piece, the only coin or token of this denomination ever issued in Canada.

Spanish dollar, 1747

United States half dollar, 1825

During the century before Confederation the supply of homemade and imported coins and tokens was supplemented by foreign coins; this greatly complicated business transactions. During the early part of the nineteenth century the commonest silver coins in circulation were the Spanish dollar, which was minted in huge quantities from the rich silver mines of Mexico and South America, and the United States half dollar.

Portugal 400 reis, 1834

Great Britain ½ crown, 1820

France 2 francs, 1817

United States 1 cent, 1855

Coins from Britain, France, Portugal and almost every other European country added to the monetary confusion that plagued Canadians before Confederation. Our forefathers had to be familiar not only with pounds, shillings and pence, and dollars and cents but also with francs, écus, pistareens, ducats, guilders and many other coins with romantic-sounding names.

Nova Scotia
penny, 1824

New Brunswick
penny, 1843

Prince Edward Island
1 cent, 1857

Rutherford Bros.
Harbour Grace, Nfld.

In the Atlantic Provinces a shortage of coins also resulted in a number of issues of merchants' tokens. The governments of Nova Scotia and New Brunswick issued penny and halfpenny tokens during the 1830's, 40's and 50's. Prince Edward Island imported light weight tokens bearing such patriotic slogans as "Success to the Fisheries" and "Speed the Plough". Newfoundland, too, had its early merchants' tokens.

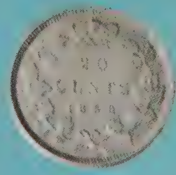
Prince Edward Island Holey Dollar

The Spanish dollar circulated freely in Prince Edward Island. As it was rated higher in Halifax than in Charlottetown the supply of these coins tended to flow out of the Island. To correct this situation Governor Smith in 1813 had the centre punched out of 1,000 of these coins so that they would not be accepted outside of the Island. The outside ring was to circulate at 5 shillings and the centre "plug" at 1 shilling.

Montreal Militia
flattened button

Hudson's Bay Company
1 Made Beaver

British Columbia
$20 gold, 1862



Prov. of Canada
20c, 1858

There were times when the supply of foreign coins, bank tokens and merchants' tokens was so inadequate that almost any circular piece of metal was acceptable as a coin. One device resorted to by some ingenious people was to remove the shanks from the backs of military buttons, flatten the buttons out and put them into circulation where they were readily accepted as halfpennies.

The Hudson's Bay Company and the North-West Company issued tokens for use in their trading posts in the far north and the far west. The unit of trade was one prime beaver skin and all other furs and trade goods were valued according to this unit.

The discovery of gold in British Columbia prompted Governor Douglas to set up a mint at New Westminster and strike $10 and $20 gold pieces in 1862. As the plan did not have Imperial approval it came to a sudden end and very few coins were struck. The illustration above is taken from a reproduction of the specimen in the museum of the Royal Mint, London.

In 1858 the Province of Canada abandoned the sterling system and the first decimal coins in the denominations of 1c, 5c, 10c and 20c were issued. In 1870, when the first coins were issued for the Dominion of Canada, the 20c piece was replaced by a 25c coin and the 50c piece was added.

During the 19th century over one hundred note-issuing banks operated in Canada. After Confederation many banks disappeared through absorption and amalgamation and this greatly reduced the tremendous variety of notes in circulation. Since 1949 (when the note-issuing power of the banks finally expired) only the Bank of Canada, which was established in 1934 by Act of Parliament, has had the authority to issue paper money. Today, 100 years after Confederation, Canadians are able to carry on their business with only one type of coin and one type of paper money.

The Centennial Coins, 1967

Published by the Bank of Canada, Ottawa, February 1967

BANK OF CANADA

Report of the Governor — 1966

Some Highlights of the Year

The year 1966 was another prosperous one for Canada. The external economic environment continued to be generally favourable, and real output in Canada again rose by more than 6 per cent. We were favoured by another very large wheat crop, and the increase in our non-farm output was also substantial. Employment averaged more than 4 per cent higher than in 1965 and the annual average unemployment rate, at 3.6 per cent, was the lowest since 1956. In the course of the year there was a welcome moderation of the intense pressure of demand on our resources but the economy continued to operate at a high level.

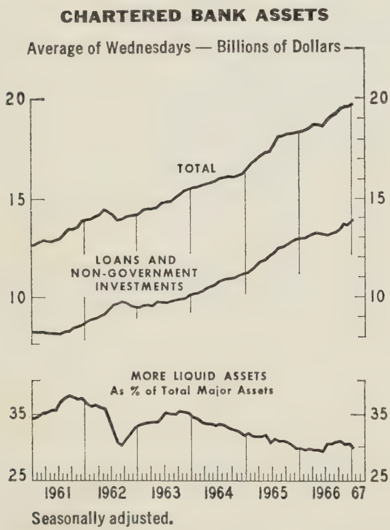
In the closing months of 1966 our total output in real terms was running some 40 per cent higher than in the closing months of 1960 before the current expansion began, and our utilization of consumer goods and services was one-third larger. Even allowing for an 11 per cent increase in our population these are very remarkable increases over so short a period. During these years we have made substantial additions to the economy's plant capacity and to its social capital in such forms as universities, schools and hospitals. Less easily measured, but no less useful, has been our progress in programmes to raise the general level of education, to increase vocational training facilities, to promote greater labour mobility, and to encourage industrial research. Such developments are favourable to the achievement of still higher levels of economic performance in the future.

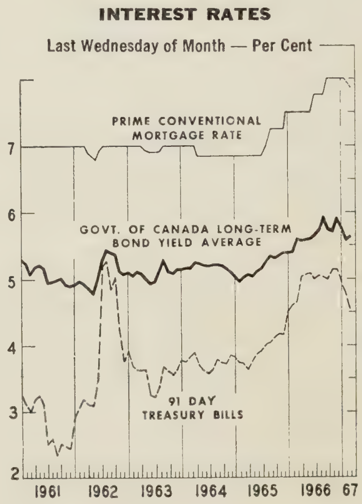
These impressive advances have, however, been accompanied in the past two years by developments in the area of productivity, costs and prices which taken together give cause for concern. The intense pressure of demand in the economy which developed in the latter part of 1965 was reflected in a very tight labour situation and an acceleration of increases in wages and salaries. The average increase in wage and salary rates last year was far in excess of any reasonable estimate of the average annual increase of output per worker in the economy, and even farther above the disappointingly small gain that, according to the figures available, we appear to have made in non-farm productivity in 1966. Despite an appreciable reduction of corporate profit margins in the course of 1966, the Canadian economy experienced its sharpest increase in prices since the mid-1950's. The broadest measure of prices, the deflator of the Gross National Product, rose by over 4 per cent in 1966, while consumer prices at the

end of the year were running 3½ per cent above their level at the end of 1965. Costs increased more, and productivity increased less, in Canada than in the United States in 1966. Diverging movements in costs and productivity such as we have been seeing recently cannot go on for long without seriously affecting the Canadian economy and in particular its international competitive position; a formidable obstacle would be placed in the way of maintaining the strong growth in output and employment of recent years.

I shall revert to some of the problems posed by these cost and price developments after giving a brief account of the major features of the Bank's monetary policy and Canada's external financial position during the year.

MONETARY POLICY. In the early years of this economic expansion, when there was still a great deal of unemployment and unused industrial capacity in Canada, the monetary policy followed by the Bank of Canada enabled the rising demand for credit to be accommodated without any tightening of credit conditions. It could be foreseen, however, that as the slack in the economy was progressively taken up, the time might arrive when a less expansive monetary policy would become necessary so as to exert a moderating influence on the growth of demand. The central bank began to prepare for this eventuality in 1964 by managing the cash reserves of the chartered banks in such a way as to reduce bank liquidity.





By the spring of 1965 the growth of the economy was rapidly bringing us back towards full utilization of the country's effective productive capacity, and the Bank's policy was to allow credit conditions to begin to tighten under the impact of heavy demands for credit.

In the latter part of 1965 and the early part of 1966 demand pressures on the economy became particularly intense and credit conditions progressively tightened. The Bank Rate was raised in December 1965, and again in March 1966 when I stated that "the Bank's action reflected its view that in the present state of the economy some moderation of the rate of growth of over-all demand was desirable". In the first half of 1966 the rate of growth of bank loans and money supply slowed markedly, chartered bank liquidity declined further and interest rates continued to rise.

During the summer of 1966 interest rates increased very sharply in the United States, and the Bank of Canada became concerned about the degree of strain that was developing in financial markets. Evidence was accumulating that the rate of growth of aggregate demand in Canada was moderating from the unsustainable rates of the latter part of 1965 and the early part of 1966. In addition, the restraining influence of monetary policy had been supplemented by new fiscal measures taken by the Government in its March 1966 budget. On the other hand, cost pressures were continuing to increase in Canada, and economic activity in the United States continued to be stimulated by strongly rising military expenditures. In addition, the Bank had of course to be concerned with the maintenance of credit conditions favourable to an adequate capital inflow. In all the circumstances, the Bank considered that the appropriate policy was for it to offer considerable resistance to a further tightening of credit conditions without, however, attempting to prevent all further upward movement in interest rates. This course involved some relaxation of the short rein it had kept on the banking system.

The shift in the stance of monetary policy about the middle of the year is clearly reflected in the trend of the money supply and bank assets. The total of currency and chartered bank deposits which had increased at an annual rate of 3 per cent in the first half of 1966 rose at an annual rate of 10 per cent in the second half. Chartered bank general loans followed a somewhat similar path: the annual rate of increase, which had been running at about 16 per cent in 1964 and 1965, was 5 per cent in the first half of 1966 and rose to 9 per cent in the second half. Under the policy followed by the central bank, the more rapid rise in bank loans in the second half of 1966 did not cause any decline in the banks' over-all liquidity; indeed, the ratio of cash, Government securities and other relatively liquid assets to total chartered bank assets rose perceptibly from its low point reached in the second quarter.

The Bank provided resistance to an excessive tightening of credit conditions in the second half of the year not only through its policies in regard to cash reserves and the growth of bank assets but also, from time to time, through direct support operations in the securities market. Some details of the Bank's operations, which were influenced to an appreciable extent by the unusual volatility of

interest rates in the United States, appear later in this Report. Even though the central bank resisted the development of extreme credit conditions, interest rates went up to very high levels. Long-term Government bond yields rose to about 6 per cent at the peak, and rates on prime conventional residential mortgages reached 8 per cent.

Although economic activity in the final quarter of 1966 was stronger than in the preceding half-year, there seemed little prospect of an early resurgence of intense demand pressures. There was also evidence of a greater public recognition that any necessary restraints on the economy should be sought through the combined operation of fiscal and monetary policy. The operations of the Bank were conducted in such a way as to permit a considerable rise in chartered bank assets to take place, and there was a general easing of credit conditions through the latter part of 1966 and into 1967. The Bank Rate was reduced from 5¼ per cent to 5 per cent on January 30, at which time I stated that "this reduction in the Bank Rate should be taken as an indication of the Bank's view that the recent easing of credit conditions was appropriate to Canada's domestic economic circumstances and its external financial position". These developments in Canadian credit conditions were of course facilitated by the similar developments that were concurrently taking place in the United States and other leading industrial countries.

As one looks back on 1965 and 1966 it is apparent that, in the attempt to contain the excessive pressure of demand on our resources and to maintain our external financial position, credit conditions were allowed to become very tight. Having regard to the uneven incidence of such credit conditions on various regions and sectors of the economy, including their particularly severe effect on the housing industry as well as their impact on financial institutions, I feel that it would not have been desirable or practicable in the circumstances to have attempted to push the use of monetary policy any further. For the same reasons I have welcomed the opportunity to encourage some easing of credit conditions in recent months.

CANADA'S EXTERNAL FINANCIAL POSITION. By comparison with most recent years, 1966 was happily free of major difficulties in so far as Canada's external financial position was concerned. The announcement of a tightening of the United States balance of payments guidelines at the end of 1965 caused considerable concern in Canada, but in the event their application did not result in any additional exchange problems. Direct investment inflows of capital increased. Canadian borrowers continued to have unrestricted access to the new issue market in the United States exempt from the Interest Equalization Tax. On the other hand, Canadians made large purchases of outstanding United States common stocks, and substantial short-term investments of funds abroad took place through the banking system.

As part of the agreement providing for unrestricted access to the new issue market in the United States, Canada had agreed to work to a reduced target figure for its foreign exchange reserves. In the course of the year the Government repatriated about $150 million of its own U.S.-pay securities and purchased about $25 million of U.S.-pay bonds of the International Bank for Reconstruction and Development. The repatriation technique of reducing reserves added an important dimension of flexibility to monetary policy in the first half of the year. We achieved our agreed reserve target—which of course contemplates a reasonable month-to-month flexibility—well before the end of the year. Over the year, Canada's reserves (including our net creditor position with the International Monetary Fund) declined from U.S. $2,880 million to $2,500 million. The Exchange Fund sold $200 million of gold to the United States and invested the proceeds in interest-bearing securities of the United States Government.

The current account deficit in our balance of payments declined by $100 million to just under $1,000 million in 1966. There are grounds for satisfaction in achieving any reduction in our current account deficit in a period of high economic activity, but it should be noted that the improvement was more than accounted for by the increase in our wheat sales and that as a result of the Canada-United States Automotive Agreement our deficit on trade in automotive products declined in 1966. On other commodities and non-merchandise transactions there was a further appreciable increase in our deficit last year.

The Bank of Canada continued to participate in various group arrangements for short-term credit between central banks. At the end of the year we were members of three such arrangements. One of the arrangements, relating to sterling, operates through the Bank for International Settlements and provides for temporary assistance to the Bank of England against the impact on Britain's gold and dollar reserves of declines in sterling balances held by non-residents. The Bank of Canada's share is up to U.S. $60 million as may be needed. The second is a more general arrangement among a number of central banks for temporary assistance to the Bank of England under which the Bank of Canada has undertaken to make up to U.S. $50 million available as required. The third arrangement is part of a network of reciprocal short-term facilities between the Federal Reserve System and a number of central banks. This network was created in 1962, and we drew temporarily our full participation of U.S. $250 million during the exchange crisis that year. The network has since grown and in the course of its further general expansion in 1966 our reciprocal facilities with the Federal Reserve System were increased to U.S. $500 million.

I believe that the experience with these arrangements among central banks demonstrates clearly that they are making an important contribution to the strength and flexibility of the international monetary system.

THE PROBLEM OF INFLATION. As I have indicated in the opening paragraphs of this Report, the record of the Canadian economy in respect of prices and costs over the past two years of high-level activity gives cause for concern. In addition to the other reasons for being concerned about inflation, we must as a practical matter achieve at least as good a cost and price performance as the United States if we are to avoid serious difficulties. For some time now we have been falling short of this standard.

Looking back, it is clear to me that for much of the last two years we have overloaded the economy. As we were approaching the limits of our productive capacity, aggregate demand was allowed to expand too rapidly for the expansion to be accommodated without major increases in costs and prices. The pressure of demand on the economy has since moderated, but a wave of cost and price increases has been generated which is continuing to move through our economic system.

A factor which contributed to the overloading of the economy was the underestimation of the strength of the North American economic expansion. This was due in part to the fact that it was virtually impossible to foresee the degree of the intensification of the war in Viet Nam and its consequences for the United States economy. But it is also the case that economic forecasting is at all times a difficult and inexact exercise. Improved forecasting must start with better and more up-to-date statistics on the past and the development of more forward-looking information on spending intentions. There are few projects that could promise a higher rate of return than a substantial investment by government and business in the provision of better information.

A better current assessment of the strength of the economic expansion would almost certainly have led to an earlier shift of the combined weight of fiscal and monetary policy towards restraining the growth of demand. Whether this might also have resulted in a different and better mix of fiscal and monetary policy is an important related question that I do not intend to pursue here. At all events, some moderation of the rate of growth of demand in the latter part of 1965 and the first part of 1966 would have been necessary to avoid the eruption of the cost and price increases which subsequently occurred.

Canada's experience over the past six years provides another demonstration of the relationship between the degree of pressure on capacity and the price and cost performance of the economy. We went into this expansion with a great deal of unemployment, and so long as a considerable amount of slack remained in the economy our price and cost performance was relatively good; it compared favourably with that of other countries despite the depreciation of the Canadian dollar. It was not until the end of 1963 that unemployment declined to less

than 5 per cent and not until late 1964 that it fell below the 4½ per cent mark. In the second half of 1965, however, the unemployment rate fell well below 4 per cent, and in the twelve months ending in June 1966 it averaged about 3½ per cent; the pressure on the labour market in this period was also reflected in the very high rate at which people were drawn into the labour force and in severe shortages of various kinds of skilled workers. (It is true that unemployment remained relatively high in certain regions of the country, but in the circumstances this could not be regarded as an effective offset to general pressure elsewhere in the economy: it was rather a measure of the size of the problem that remains to be dealt with by policies specifically directed towards particular areas or localities.) In 1965 and 1966, when the slack in the economy was taken up, there was a marked deterioration in our cost and price performance. Admittedly, some special factors contributed to this result, such as those that gave rise to the sharp increase in food prices. The problem was also exacerbated by unevenness in the pressure of demand; the pressure on the construction industry was particularly intense. But whatever weight may appropriately be attached to such special factors, it remains the case that the pressure of aggregate demand on the economy exceeded that which we were able to accommodate within a framework of reasonable cost and price stability.

The maintenance of reasonable cost and price stability in our society also depends on the vigour of competitive forces in the market. In point of fact, however, these forces may not be strong enough when the economy is operating close to the limits of its effective capacity. If we also take account of the fact that bottlenecks develop well before this point is reached and that certain groups are in a position to deploy unusually strong market power, the problem of maintaining reasonable cost and price stability is seen to be formidable.

This problem has been experienced from time to time by all countries that attempt to operate market economies at high levels—the difficulty of having more ambitious targets with respect to output than the country's practices for determining incomes are able to handle consistently with reasonable cost and price stability. It must unfortunately be acknowledged that no country has found a completely satisfactory solution to the problem. But the problem cannot be avoided.

I believe that most Canadians reject the thesis that we can or should accept inflation as a means of achieving high rates of output, and this has been made clear in various ways during the past year. For my own part I do not believe that this option is really open to us. I know that in recent years high rates of price increase have tended in general to be associated with low levels of unemployment. But I think it would be a serious mistake to infer from this that if

only we were willing to accept high rates of price increase as a norm it would be easier to maintain low unemployment levels over an extended period. If this approach were adopted, the public would soon realize what was happening and would take whatever economic or political actions were available to it to protect itself against the officially-sponsored expectation of a continuous and rapid decline in the value of money. It would soon become just as difficult to prevent price rises from exceeding a high target rate as it now is to prevent them from exceeding a low target rate. The same policies of restraint would come to be required. Nothing would be gained in employment or output; the difficult efforts to adjust to inflation would thus have been to no avail and our ability to grow steadily would be continuously threatened by the impairment of our international competitive position.

It would be possible to avoid cost and price inflation by lowering our sights with respect to the levels of employment and output that should be sought. This would involve the maintenance of a margin of unused resources large enough to keep price and cost pressures from developing to the point where widespread rises occur. Unfortunately it seems likely that this would result in a greater degree of unemployment and under-utilization of capacity than most of us would find acceptable.

I hope that we can do better than this. I hope that we can find a way to operate the economy at a high level of activity without price instability by a combination of better management of demand, better policies on the supply side to increase the efficiency and productivity of the economy, and better performance of the income-determining machinery in our society. In connection with the latter, it is clear that as a minimum there must be a realistic appreciation on the part of the public of the scale of the benefits the economy can physically provide through increases in output, and of the consequences of a failure to be competitive with other economies. A good deal of the recent discussion regarding this matter has revolved around the great difficulties associated with specific guidelines for wages and prices. It has to be borne in mind, however, that with or without publicly-sponsored guidelines, patterns do emerge. It is essential that these patterns be realistic. There is very little to be said in favour of income negotiations, often difficult, prolonged and costly to all concerned, which lead to agreements that are bound to be greatly amended in their final effect by subsequent increases in prices. As a matter of simple economic arithmetic, the real income of the community is inevitably limited by the amounts we can in fact produce. You cannot get a quart of wine out of a pint jug.

The stake of the whole community in the maintenance of reasonable price stability and a competitive economy is so great that the normal reliance on market

forces in the process of price and income determination needs to be reinforced by the constant pressure of informed public opinion. In this matter the attitudes and actions of governments are particularly important, not only because of the size of the government sector and closely related sectors of the economy, but also because of the disposition of others to follow patterns set, or acquiesced in, by governments. In the public sector there would appear to have been room for the smoother adjustment of incomes over time, so that equity could be maintained without occasional disruptive adjustments. In general, there is need for much more study and discussion of the relationship between productivity trends on the one hand and change in prices and incomes on the other in order to provide the public with the means of forming an objective judgment as to what price and income developments are inherently inflationary.

INTERNATIONAL MONETARY SYSTEM. During the past year officers of the Bank have continued to participate actively along with officials of the Department of Finance in discussions, in the International Monetary Fund and the Group of Ten, on means of improving the international monetary system. These discussions look towards the next step in the evolution of the international monetary system. The major forward steps during the past fifty years have been the transition from an international gold standard to a gold and exchange standard, with sterling and the U.S. dollar serving as reserve currencies; the establishment of the International Monetary Fund to promote exchange rate stability and the orderly adjustment of their positions by countries in balance of payments difficulties; and the development of central bank co-operation involving a substantial structure of short-term credit facilities. The most recent stages in this evolution have been marked by much more intensive international discussion of the payments problems confronting individual countries as well as of the functioning of the international financial machinery.

The current discussions have revealed agreement that the international monetary system needs to be improved in two respects. Better performance is needed by countries individually in achieving and maintaining a suitable balance between their international payments and receipts; and better arrangements are needed to provide for an orderly increase in international liquidity as world trade and payments grow.

These are in fact different aspects of the same problem, that of achieving an international payments system which will encourage the smooth growth of world trade and capital flows. For this to be accomplished, countries must so manage their affairs that imbalances in their international payments position can be kept within acceptable limits by means that are not disruptive of world trade or capital

flows. To help them accomplish this objective, they must have available enough access to international reserves or other sources of external financing to provide time for them to achieve smooth adjustments in their external positions, but not so much as to encourage them to postpone action to deal with emerging external imbalances.

The problems involved in achieving and maintaining a suitable balance in external payments are complicated and difficult. The main reason is that governments rightly feel that they must seek external balance by means which do not prejudice the attainment of other objectives of public economic policy such as high employment, a satisfactory rate of growth, and reasonable price stability. It is much more difficult to find blends of economic policies that will achieve all of these objectives at the same time than it is to achieve any one of them by itself. In actual practice, countries are frequently tempted to give priority to their internal economic objectives and to hope that the external balance of the economy will somehow or other look after itself. If they yield to this temptation they run the risk that their external positions will become unmanageable and will eventually require remedial policies so severe as to prejudice the attainment of their internal objectives. In the meantime their erratic economic performance will have seriously complicated the economic problems of their trading partners.

Last August the Organization for Economic Co-operation and Development published a report by Working Party 3 of its Economic Policy Committee on the balance of payments adjustment process which outlines well the complexity of the problem. It stresses the inadequacy of any simple or automatic solutions, the contribution that can be made by better diagnosis of payments problems and the more flexible use of economic instruments, and above all the importance of a common will on the part of national authorities to give proper weight to, and to co-operate in achieving, equilibrium in their external accounts.

If we are to have national policies that are conducive to the smooth adjustment of countries' international payments positions we must ensure that such policies are encouraged by the international arrangements in respect of liquidity —that is, by the arrangements governing the volume of international reserves and access to short-term credit. On the whole these arrangements have evolved very well in the years since the Second World War, but some major weaknesses have become apparent in recent years. Though the growth in the role of the U.S. dollar as a reserve currency has been helpful, the increase from year to year in the amount of U.S. dollars in the hands of non-residents depends in part on the balance of payments of the United States, and there is no satisfactory way of ensuring that the United States payments balance will be responsive to the world's needs for international liquidity. Moreover, it is the consensus of

opinion, including that of the United States Government, that the stock of U.S. dollars in the hands of non-residents is about as high as is warranted in present circumstances. It does not therefore seem appropriate to count on the U.S. dollar to provide any major part of the growth in official reserves which the international monetary system will need in order to accommodate the growth in world trade and payments in the years ahead.

Gold has been and still is the principal component of countries' international reserves. If there were any prospect of a substantial growth in the future in the stock of gold in the hands of national monetary authorities, international concern about any future inadequacy of international liquidity would diminish. But there appears to be no such prospect. In recent years the annual additions to national monetary gold stocks have been relatively small; indeed there appears to have been no addition at all in 1966. There are some who believe that the best means of adding to international liquidity would be to increase the effective size of the monetary gold stock by raising the price of gold but the great majority of those concerned hold the view that this would be an unsatisfactory and disruptive way of dealing with the problem.

In the circumstances described, it has been clear for some time that the countries of the world should reach a decision on how they are going to satisfy future needs for international liquidity. In view of the apparent certainty that action will sooner or later be necessary, the absence, after the prolonged discussions which have taken place, of a firm agreement on what action should ultimately be taken gives rise to uneasiness in financial markets. I therefore believe that international agreement on a plan is a matter of considerable urgency.

The international discussions that are going on have shown that there is in fact a substantial consensus on a number of important points. Given the will to act, agreement on the remaining issues should be attainable. The precise details of the plan are of less consequence; various arrangements would be workable and effective if they received the support of the world's principal trading countries.

There is a great deal of support—in which I join—for the creation of a new international reserve unit, to be backed by the currencies of all members of the International Monetary Fund who wish to participate, and to be distributed among participating members in accordance with some objective criterion of their international economic role, such as the relative size of their quotas in the Fund. A unit of this kind, with its value fixed in terms of gold, could be created and distributed by the Fund, or preferably by an affiliate of the Fund, in such amounts as by international consensus seemed appropriate over the years ahead to supplement gold and the reserve currencies as a component in countries' international reserves.

It is of course essential to ensure that any new reserve unit which is created should be widely and readily acceptable. There are various specific arrangements that could achieve this. Ultimately, however, the acceptability of a new reserve asset will depend upon the wisdom of the decisions on the amounts of it which are created. The nature of the decision-making process is therefore of great importance. The decision-making machinery must offer protection against two extremes—against irresponsible and opportunistic liquidity creation in an attempt to escape from better but less popular action in other areas, and against overly-cautious management. Given a good voting system to back it up, there is reason for confidence that decision-making would not in fact be done by voting but rather by a process in which consultation in various forums resulted in a widespread international consensus. This is how decisions are now normally reached in the Fund.

I share the widely-held view that it is desirable to separate the decision to establish machinery for the creation of international liquidity from the decision to put the machinery to use in creating additional liquidity after it has been established. I believe, however, that there is now a real need for the responsible authorities to demonstrate that they will in fact be able to create international liquidity when it becomes necessary. It will take time to work out the details of the required international agreement and to get the necessary legislative authorizations. If we do not put the machinery in place until it is obvious to all concerned that there is an immediate need for additional liquidity we shall have waited too long.

The External Economic Environment

Canada's external economic environment continued to be favourable in 1966. Output in most industrial countries rose strongly, as did total world trade. At the same time, however, signs of strain became more pronounced in a number of countries. In North America the disappearance of the earlier margins of unused resources was reflected in rising costs and prices, and similar pressures continued to be experienced in a number of Western European countries. The task of containing these inflationary tendencies fell largely on monetary policy and interest rates rose to their highest level in several decades. In the course of the year, however, some signs of reduced demand pressure emerged and towards year-end interest rates were easing. In the course of 1966 the international payments system was again subjected to a number of strains but some countries made significant progress in reducing the imbalances in their payments positions.

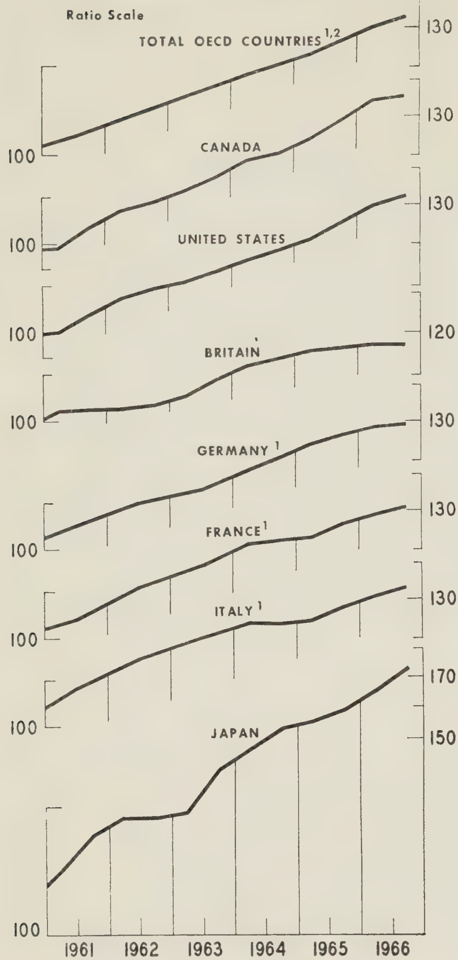
OUTPUT, EMPLOYMENT AND PRICES. For the OECD countries as a group, which account for the great bulk of our external trade, total output again rose in 1966 by an amount roughly in line with the 4½ to 5 per cent average annual increase experienced since the early 1960's. In the early months of 1966 there was a rapid expansion of over-all demand, but some easing occurred during the balance of the year. Public expenditures continued to expand steadily through the year, so changes in the rate of growth of output were attributable mainly to demand in the private domestic or foreign sectors.

Of particular importance to Canada was the continuation of economic expansion in the United States. The value of Gross National Product in that country rose by 8½ per cent in 1966 compared with a little less than 8 per cent in 1965. However, prices rose more in 1966, and in real terms the growth is estimated at 5½ per cent compared with about 6 per cent in 1965. During the years 1961 to 1965 the expansion of the United States economy had been greater than the growth in its long-term potential, and effective slack appears to have been largely eliminated by the end of 1965. The trend of output continued upward throughout 1966 but the pace of expansion slowed considerably in the

GROSS NATIONAL PRODUCT

Constant Prices

Semi-annual – Index 1960=100



Seasonally adjusted.
1966 preliminary estimates.
1. Annual plots prior to 1964.
2. Includes countries shown plus Austria, Belgium, Denmark, Greece, Iceland, Ireland, Luxembourg, Netherlands, Norway, Portugal, Spain, Sweden, Switzerland and Turkey.

second quarter. Notwithstanding some easing in the demand for automobiles and a sharp decline in outlays on housing construction, over-all demand strengthened again in the second half of the year, largely reflecting rising military expenditures and sharply higher inventory accumulation. Excluding military expenditures, however, the growth in final demand was relatively slow. In the final quarter of the year, plant and equipment investment had slowed down and automobile sales were below their year-earlier rate. On the other hand, housing starts, though still low, were rising and military expenditures were continuing to increase strongly. The official United States forecast is for a continuation of the expansion through 1967; over the year as a whole GNP in real terms would expand nearly in line with the 4 per cent growth in potential.

In France, Italy and Japan the upward movement which was resumed in 1965 became more firmly established in 1966 and strong growth continued throughout the year. The stimulus came largely from export demand but during the course of the year the upward movement became more broadly based as consumer demand recovered; by year-end there was evidence of renewed strength in private investment as well.

The pace of growth in real output in most other European countries, where the margin of slack had been reduced to low proportions by the beginning of the year, was somewhat slower in 1966 than in the previous year. Economic growth in Britain and Germany slowed markedly in the course of the year. This was associated with a weakening in consumer demand, particularly for durables, and

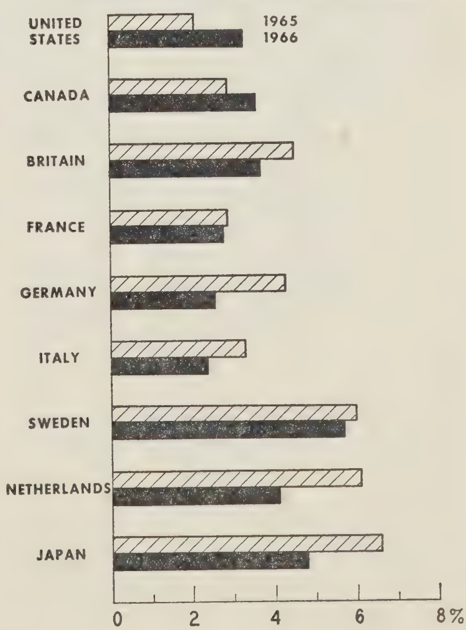
an easing in total investment. In Britain the development of the economy was, of course, influenced by the measures taken to deal with the balance of payments problem. Lower rates of growth in a number of other European countries in the latter part of the year were related to a considerable extent to the easing in demand in the important British and German markets. Throughout Europe the construction sector was relatively weak in 1966.

By the end of the year there was a fairly general easing in labour markets in overseas industrial countries. The rise in unemployment was particularly sharp in Britain in the second half of the year and the recoveries in France, Italy and Japan had not yet reduced the level of unemployment significantly.

In the United States total employment continued to advance strongly in 1966. After the first quarter the gains just about matched the growth in the labour force, and the unemployment rate, which had fallen steadily from 5½ per cent early in 1964 to a little less than 4 per cent in the first months of 1966, remained relatively stable through the balance of the year. The 5½ per cent increase in real output in 1966, taken in conjunction with a 3.0 per cent rise in total employment, suggests that output per worker increased somewhat less than in 1965.

Cost and price pressures intensified in North America in 1966 and continued to be a major area of concern in most other industrial countries. Despite the slower rate of growth after the first quarter the United States economy continued to operate close to capacity levels; demand pressure remained strong throughout the year. Labour income expanded more rapidly. There was some deterioration in the relatively good unit labour cost record of recent years. The GNP price index of all goods and services rose by 3.0 per cent compared with 1.8 per cent in 1965. The Consumer Price Index rose by 3.3 per cent in the year ended December 1966 compared with an increase of 2.0 per cent over the previous twelve-month period. Only a limited number of labour contracts were negotiated in 1966, but they provided for wage increases substantially higher than those obtained

CONSUMER PRICE INDICES
Percentage Increase : 12 Months Ending December



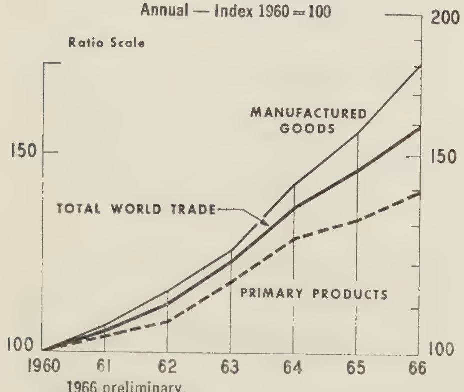
in earlier years and appreciably above the rates indicated by the wage "guideposts" that were in effect during the year. The size of the wage and fringe benefit gains tended to increase as the year progressed. The Council of Economic Advisers states in its Annual Report that ". . . the experience of 1966 clearly suggests that expanding demand cannot lower the unemployment rate much below the present level without bringing an unacceptable rate of price increase. Under present conditions, an over-all unemployment rate close to 4 per cent appears to be associated with an approximate balance between supply and demand in most labor markets. A higher level of demand for goods and services would create inflationary pressures in both product and labor markets."

In the past two years there has been some easing in the upward trend of prices in France and Italy, and since mid-1966 the rise in consumer prices in Germany appears to have tapered off. The upward trend in costs and prices in Britain was halted after the introduction in July of a six-month freeze on prices and incomes, which is to be followed by a period of "severe restraint" regulated by stringent guidelines. While most other European countries continued to experience relatively rapid price increases, the rate of increase in many cases was lower than in 1965.

TRADE AND PAYMENTS. The expansion of world trade in 1966 seems to have been about in line with the relatively high average rate of almost 10 per cent experienced in the previous three years. Part of the rapid increase in international trade in recent years reflects the expansion of trade within trading blocs where barriers to bloc trade have been progressively reduced. Trade within the European Economic Community and within the European Free Trade Association has consistently grown more rapidly than world trade since 1959. The same observation applies to the growth of trade within the Latin American Free Trade Association and within the Central American Common Market since 1961, though in these areas intra-area trade accounts for a relatively small part of total trade. However, the growth of world trade, even excluding intra-area trade, has been relatively rapid in the past few years. An important element sustaining the growth in trade in 1966 was the continued rapid rise of imports into the United States. Import demand also accelerated in France, Italy, Japan and in the less developed countries. Trade in manufactures

WORLD TRADE[1]

Annual — Index 1960 = 100



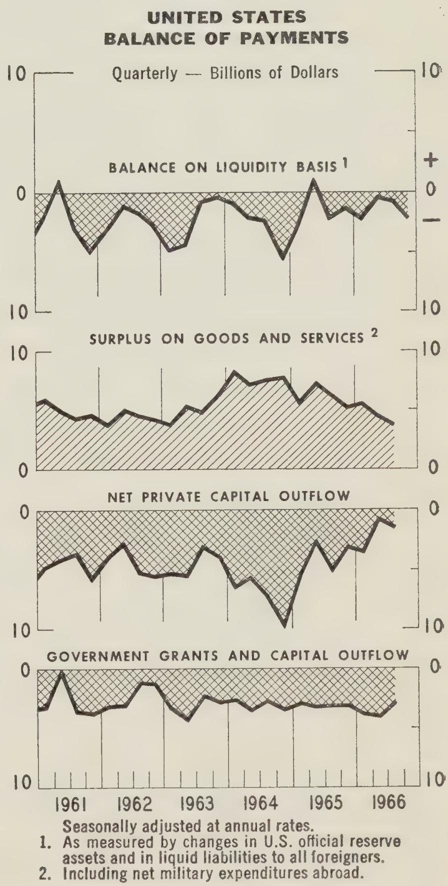
1966 preliminary.
1. Total exports f.o.b.

continued to grow more rapidly than trade in primary products; in part this reflected the easing in primary commodity prices in 1966.

Among the primary producing countries, those whose principal exports are petroleum, minerals or metals did relatively well in 1966; the demand for these products remained buoyant even though prices were somewhat lower in the second half of the year. On the other hand, the countries dependent on the export of tropical agricultural products fared less well; prices of these products declined throughout the year. World demand for wheat and flour was strong, reflecting poor crops in many areas and the further depletion of stocks in some of the major producing countries. The situation was particularly serious in India which suffered drought conditions for the second successive year; crops in China were also poor. The Soviet Union had record grain crops in 1966 following two years of relatively poor crops, but imports remained large.

The diverse changes in economic activity and in the underlying demand pressures on available resources which have been described were reflected in the developments of the international current account positions of the industrialized countries.

In the United States, there was a further reduction in the surplus on goods and services transactions in 1966. United States imports rose almost twice as rapidly as exports and the trade surplus declined to $3.7 billion, from $4.8 billion in 1965 and $6.7 billion in 1964 although there was some increase in the trade surplus in the final quarter of the year. The favourable balance on services account (excluding military expenditures) apparently rose slightly as investment income receipts continued to grow; however, when account is taken of military expenditures abroad, which increased sharply, the combined surplus on goods and services dropped by about $1.5 billion from the $6.0 billion figure reached in 1965.



A number of countries which had experienced deficits on current account in 1965 tended to improve their positions in 1966. The German current account deficit contracted rapidly and had been replaced by a surplus by year-end. Britain was also moving into current account surplus towards year-end though results for the year as a whole were adversely affected by the seamen's strike in the early summer.

On the other hand, as the pace of domestic activity in France and Italy accelerated, their large current account surpluses tended to contract, especially during the second half of the year. Japan maintained its surplus position in 1966, largely reflecting the export-oriented character of the economic expansion, but towards year-end there were indications that the broadening basis of its recovery was leading to some reduction in the surplus.

The reduction in the external surplus on goods and services in the United States in 1966 was largely matched by a reduced net capital outflow, and the balance of payments deficit on a liquidity basis* increased only slightly to $1.4 billion, from $1.3 billion in 1965. The outflow of United States private capital was restrained by the voluntary guidelines, and United States business corporations financed a considerable part of their foreign investment by the sale of bonds, denominated in U.S. dollars, in European capital markets. It appears nevertheless that the reduction in the net outflow of capital from the United States in 1966 reflected mainly large purchases by foreign official institutions of non-guaranteed securities of United States Government agencies and long-term certificates of deposit issued by United States commercial banks, which are not included in the calculation of the liquidity deficit. An important effect of domestic credit stringency in 1966 was that United States banks borrowed substantial amounts of short-term funds from private non-residents through the Euro-dollar market; this unusual borrowing no doubt reduced the flow of dollars into foreign official reserves.

The world payments situation was characterized by an unusually large volume of international short-term capital flows in 1966. In the summer months substantial outflows from Britain were countered by the expansion of various central bank credit facilities. Short-term funds were attracted to some countries that were accumulating reserves, including Germany. To a large extent, however, short-term flows played an offsetting role, as in the case of the United States noted above, and in the cases of Italy and Japan, where short-term outflows helped to offset current account surpluses. Large amounts of these short-term funds were in U.S. dollars and moved through the international network of private

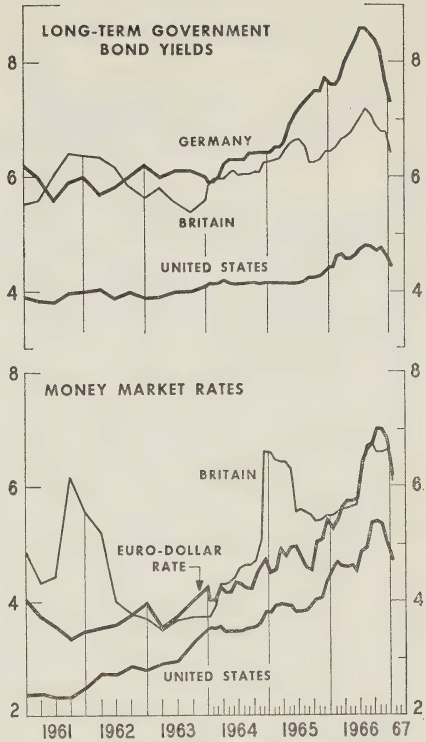
* As measured by changes in United States official reserve assets and in liquid liabilities to all foreigners.

financial institutions that make up the Euro-dollar market. The increase in short-term capital flows was associated in part with a very sharp rise in short-term interest rates which in 1966 reached peak levels not experienced since the 1920's.

The flow of development capital to the less developed countries has continued to be adversely affected by the international payments problems of some major contributing countries. Despite the growth in production and income in the industrialized countries the total flow of official aid has remained virtually constant over the past five years. Moreover, financial developments in the industrialized countries have made it more difficult for both international organizations and private investors to mobilize new development capital. Rising debt repayments have resulted in an actual decline in the net capital flow to the developing countries in recent years.

SELECTED INTEREST RATES

Per Cent

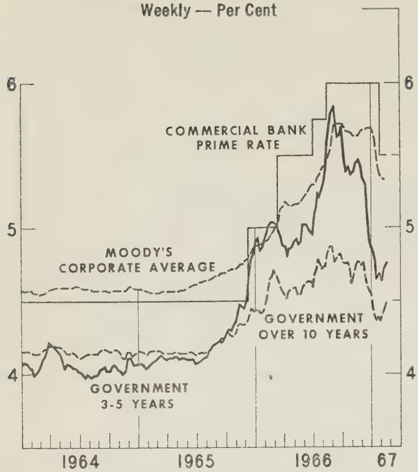


Quarterly prior to 1964, monthly thereafter.

FINANCIAL POLICIES. In the United States, monetary and fiscal steps directed to meeting the dangers of overly-rapid expansion were taken at the end of 1965 and early in 1966. With the large growth in defence expenditures, fiscal policy did not provide the degree of restraint that had been intended. Credit demand continued to grow and the task of offering additional restraint fell largely on monetary policy. In August, as the chart on the next page shows, interest rates reached very high levels and conditions in credit markets became very strained. Efforts were made to moderate the growth in bank loans to business and in order to help achieve a better mix of financial policies fiscal measures were taken in September to limit the growth of business investment and to cut back non-defence expenditures. Later in 1966, as it became clear that demand and supply in the United States economy were moving towards better balance, monetary policy became less restrictive. This was first reflected in lower market yields on United States Treasury securities, but early in 1967 the easing in interest

UNITED STATES INTEREST RATES

Weekly — Per Cent



rates became more general. In his budget message in January 1967, the President asked Congress to enact a temporary 6 per cent surcharge on personal and corporate tax liabilities to be effective at mid-year to cover a large part of the projected increase in Government expenditures. The President also asked for an extension of the Interest Equalization Tax for two years to mid-1969 and an immediate doubling of the effective rate to 2 per cent, with authority to adjust the tax so that its effective impact can be varied from zero to 2 per cent. The Administration has extended through 1967 the voluntary balance of payments programme introduced early in 1965, with a lower target for direct investment abroad.

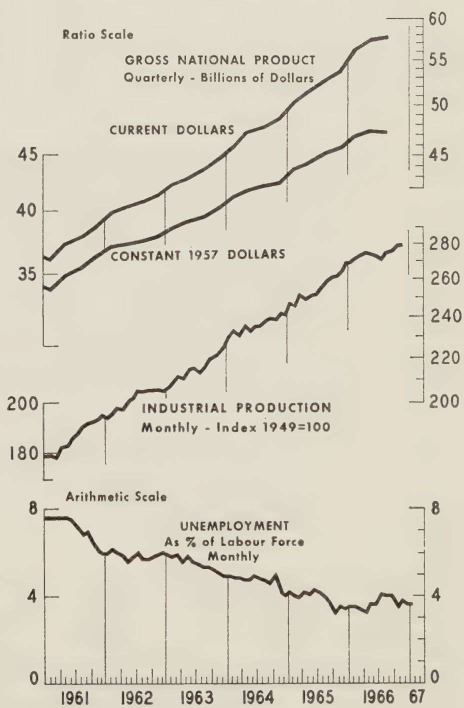
Since 1964 economic policy in Britain has been greatly influenced by the need to restore internal and external balance and to strengthen confidence in sterling. The additional measures of fiscal restraint introduced in the May 1966 budget were substantially reinforced by steps taken in July, including a freeze on prices and wages. Fiscal action was accompanied by an increasingly restrictive monetary policy and the Bank Rate was raised from 6 to 7 per cent in July. Through the summer months the position of sterling in the exchange market remained uncertain, and it was supported by a substantial increase in central bank credit facilities. Sterling subsequently strengthened, and since September reserves have recovered and there have been repayments of official short-term liabilities. In November the remaining emergency import surcharges were removed. The Bank Rate was lowered by ½ per cent to 6½ per cent in January 1967.

In France, Italy and Japan economic policy in 1966 continued to be directed towards sustaining economic expansion. In almost all other European countries the level of demand was high in the first part of the year and measures were taken to restrain price and cost pressures. The mix of public policy in these latter countries continued to place heavy reliance on monetary restraint. Several central banks raised their rediscount rates and as noted earlier the structure of international interest rates rose sharply. However, a moderation of the pressure of demand in the second half of the year, which was particularly marked in Germany, permitted some easing in restrictive policies. Early in 1967 the rediscount rate was reduced twice in Germany and it was also lowered in Sweden and Belgium.

Economic Developments in Canada

Against the background of continued expansion in the United States and the strong growth of world trade described in the preceding section, the Canadian economy made further substantial gains in 1966, though there was considerable evidence of stress and strain. A record wheat crop coincided with strong export demand, and production in the non-farm economy registered further advances, particularly in the early part of the year. Economic activity grew more slowly after the first quarter than it had through the winter and there was some easing of the pressure on resources. The trend of output was relatively flat during the summer, partly as a result of strikes, but the pace of activity picked up in the closing months of the year. At year-end the economy continued to operate at high levels of employment. However, there were uncertainties about the economic situation, related partly to the course of developments in the United States and partly to the ultimate repercussions of imbalances generated by the strong domestic pressures in 1965 and early 1966. Among the signs of imbalance were numerous industrial disputes, wage settlements substantially in excess of productivity growth and pervasive increases in prices.

OUTPUT AND UNEMPLOYMENT



Seasonally adjusted (GNP at annual rates).

Gross National Product in money terms is estimated to have been more than 10½ per cent higher in 1966 than in 1965. To an important extent this large increase reflected the very sharp rise, amounting to 4½ per cent, in the first quarter of the year. The increase in 1966 exceeded that of the previous year by

about 1 per cent; it was the largest rise since 1956. However, two fifths of the increase was accounted for by higher prices rather than higher real output of goods and services. The GNP price deflator rose by more than 4 per cent in 1966 compared with an increase of about 3 per cent in 1965. After allowing for this large price factor, the gain in total output in 1966 was slightly more than 6 per cent, or marginally less than in the previous year. As a result of the record wheat crop, agriculture contributed more than proportionately to the increase in output in 1966 and non-farm real output rose by nearly 6 per cent compared with over 6½ per cent in the previous year. On the other hand, non-farm employment rose more in 1966 than in 1965—5.4 per cent compared with 4.8 per cent. These figures indicate that the gain in productivity in 1966, as measured broadly by non-farm output per worker, was disappointingly small.

The principal source of the increase in non-farm employment in 1966 was the growth in the labour force, which was the highest since 1957. The movement out of farm employment was also larger than it had been at any time since the mid-1950's. The seasonally adjusted unemployment rate which had declined to just under 3½ per cent by the last quarter of 1965 fluctuated in the 3½ to 4 per cent range in the course of 1966 and ended the year just over 3½ per cent.

During 1966 there were marked shifts in both income and expenditure patterns, which in many cases had already begun to be significant in 1965.

On the income side, a notable feature of the year was the comparative behaviour of labour income and corporate profits. Labour income grew strongly as a result of higher employment and increased average earnings. Even though many of the large wage settlements which occurred in the course of the year were not yet fully reflected in earnings, labour income for 1966 rose by about 12½ per cent—the largest increase in a decade. On the other hand corporate profits, which had risen more strongly than labour income in the earlier part of the expansion—reflecting in part their greater cyclical variability—levelled out in the latter part of 1965 and fell in the second half of 1966. For the year as a whole corporate profits showed little change from the previous year and they declined relative to total income and to real output. The most striking increase in income during 1966 accrued to the farm sector; the net value of farm production (as measured in GNP), reflecting principally the size of the wheat crop and the higher level of livestock prices, rose by almost 40 per cent in 1966 to much the largest figure on record.

The demands placed on the economy by various sectors changed significantly during the year. In Canada, as in the United States, automobile and housing markets exerted a dampening influence. On the other hand, the traditionally more stable elements of personal spending continued to provide strong support to the economy. The extended boom in business investment which began in

1963 continued into 1966. All levels of government made large increases in their expenditures on goods and services. There was a slight improvement in the current account deficit, which contrasted with a significant deterioration in 1965. In response to the strong general demand situation in the United States and the favourable factors affecting wheat exports, total exports registered a much larger increase in 1966 than in 1965 while the rise in imports, though large, was of about the same magnitude as in 1965.

DOMESTIC DEMAND. After four years of rapidly rising sales, the North American market for new automobiles weakened significantly in 1966. This development may have been related in part to the controversy over safety features, but it seems reasonable to suppose that it also reflected the large additions to the automobile population which had taken place in recent years; the changes which occurred in credit conditions probably also had an influence. The pattern of sales in Canada throughout the year was uneven. A particularly sharp dip in the spring was followed by a period of very high sales in the summer as automobile dealers made a major effort to clear their stocks of 1966 models. This unevenness was magnified to some extent by a spurt in buying prior to, and a reaction following, the increase in the Ontario sales tax on April 1, 1966. For the year as a whole sales of new automobiles declined by about 2 per cent compared with an increase of about 15 per cent in 1965. In the closing months of 1966 sales in both Canada and the United States were running 6 to 8 per cent below their levels of a year earlier.

As 1966 progressed, there was evidence of a tapering off in the rate of increase in personal spending on household and other durable goods as well as on automobiles. However, personal expenditures on non-durables and on services increased even more strongly in 1966 than in the previous year—to some extent reflecting higher prices, particularly for food. In total, personal expenditure is estimated to have been about 8½ per cent higher in 1966 than in 1965. At the beginning of 1966 payroll deductions were increased as a result of the inception of the Canada and Quebec Pension Plans, and effective June 1 federal tax rates on personal incomes, except in the lower brackets, were increased by about 10 per cent, which approximately reversed the tax reduction which occurred at mid-1965. Nevertheless, personal disposable income increased at almost the same rate as in 1965. The increase in personal disposable income was greater than in personal spending, so there was a further increase in the proportion of disposable income saved in 1966. The high level of personal saving probably reflected in part the sharp increase in farm income. The relationship between spending and income may also have been affected by credit conditions: during the course of the year there was a tendency for the amount of consumer and mortgage credit outstanding to rise less rapidly.

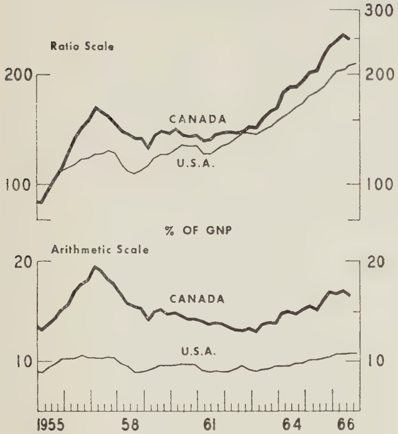
Housing starts turned down in the latter part of 1965 and continued to decline sharply through most of 1966, being adversely affected by the shortage of mortgage funds. The level of house-building activity remained high in the first half of 1966 as work continued on the large volume of earlier starts, but in the second half of the year expenditure on new residential construction declined quite sharply. As was the case with the earlier upswing in starts, most of the decline was in apartments and row houses whose financing is mainly dependent on private financial sources. Starts of single family dwellings were supported by an increase in direct government loans and were maintained close to the relatively stable level that has prevailed in recent years. Multiple starts were almost one-third lower in 1966 than in the previous year while single starts were down by about 6 per cent. As the chart on page 27 shows, the recent decline in housing starts has not been as sharp as on similar occasions in the past nor as sharp as that which occurred in 1966 in the United States; it may also be noted that the upswing in starts which preceded the contraction was much stronger in Canada than in the United States. On the other hand, Canada has a higher natural rate of household formation than the United States and has recently had very high rates of immigration as well. Vacancy rates in Canada have fallen to extremely low levels and there has been a sharp rise in house prices and rents, particularly in rapidly growing metropolitan centres. Late in 1966 and early in 1967, the Government announced a number of measures designed to stimulate house-building activity. A programme of direct government loans to builders similar to that used to promote winter-building was announced for the spring months of 1967. To encourage the flow of private funds into the mortgage market, the maximum interest rate on National Housing Act insured mortgage loans, which had been raised to 6¾ per cent in January 1966, was fixed at 7¼ per cent in November and arrangements were made for future automatic adjustments in this rate at quarterly intervals.

Business fixed investment in 1966 registered an increase in the 17 to 20 per cent range for the third successive year. The 1966 increase, though again large, was substantially smaller than the 23 per cent rise indicated by the mid-year review of investment intentions; the results of this survey had suggested that investment was continuing to increase apace, despite the various changes in public policy aimed at restraining it to more sustainable rates. Several such measures were introduced in the March 1966 budget, notably a reduction in depreciation allowances on a wide variety of new plant and equipment acquired between the date of the budget and October 1967, the introduction of a 5 per cent refundable tax on corporate cash flow (broadly, after-tax profits plus depreciation) in excess of $30,000, and the announcement of the removal of the 11 per cent federal sales tax on machinery and equipment in two stages beginning April 1, 1967. In the latter part of the year signs began to appear that the investment boom was

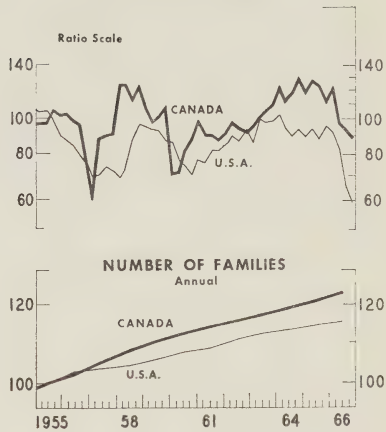
SELECTED COMPARISONS
CANADA - U.S.A.

Quarterly — Index 1955 = 100 (Unless Otherwise Noted)

BUSINESS FIXED INVESTMENT

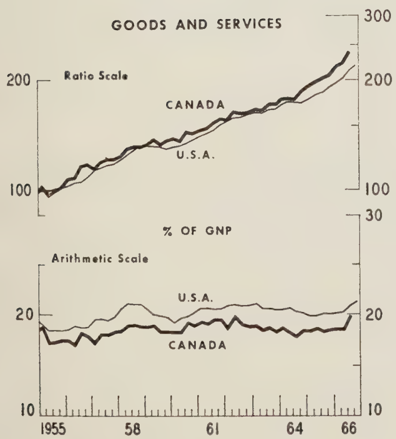


HOUSING STARTS



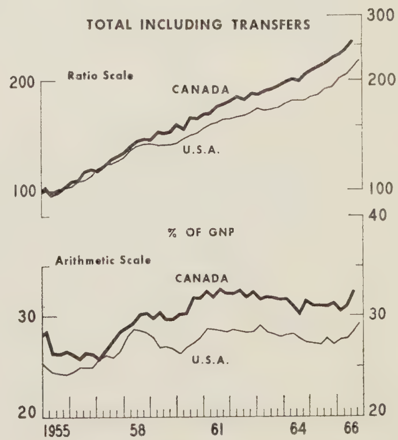
GOVERNMENT EXPENDITURE : ALL LEVELS

GOODS AND SERVICES



Seasonally adjusted at annual rates.

TOTAL INCLUDING TRANSFERS



moderating. Preliminary estimates of the third quarter national accounts showed a reduction in non-residential construction, and an official survey of large firms made in the autumn indicated that they were not expecting their total investment outlays on plant and equipment to be much higher in 1967 than in 1966.

Expenditures of federal, provincial and municipal governments continued to rise rapidly in 1966. As the chart on page 27 shows, expenditures by governments have been rising faster in Canada than in the United States despite the very large increases in United States outlays associated with the war in Viet Nam. In Canada, government expenditures on goods and services rose by 15 per cent in 1966 compared with 11 per cent in 1965. In contrast to 1965 federal government expenditures rose faster than provincial-municipal expenditures in 1966. (It should be noted, however, that provincial-municipal outlays on goods and services are now almost twice as large as those of the federal government.) Increased wage and salary costs were a major factor for all levels of government in 1966. Federal expenditures on goods and services rose by 18 per cent in 1966 compared with 7 per cent in 1965. Defence expenditures, which had declined slightly in 1965, rose by about 9 per cent in 1966; the major acceleration was in other types of expenditure which rose by about 27 per cent in 1966 compared with a rise of 16 per cent in 1965. At the provincial-municipal level, expenditures on goods and services rose by about 14 per cent in 1966, about the same rate as the previous year. Capital outlays for roads, schools and other public works registered a further large increase in 1966.

In addition to increasing their direct purchases of goods and services, governments continued to expand their transfer payments to other sectors of the economy at a rapid rate during 1966. Old age security payments rose appreciably as a result of the first of the scheduled annual reductions in the eligible age, and there were further large increases in grants to universities, vocational schools and hospitals, both for capital expansion and to meet current operating expenses. Other transfer payments, which include interest on the public debt and various subsidies, also rose substantially. In total, transfer payments increased by about 11 per cent in 1966 compared with 7½ per cent in 1965.

The total increase in federal, provincial and municipal government expenditure was about 14 per cent in 1966 compared with 9½ per cent in 1965. Total revenues (excluding the Canada and Quebec Pension Plans and the refundable corporate profits tax mentioned previously) rose by about 10 per cent compared with 11½ per cent in the previous year. The principal factor leading to the slower growth of revenues in 1966 was the failure of corporate profits to increase. At the federal level, total expenditures rose by about 14 per cent in 1966 and revenues by about 8 per cent. Revenues were strengthened during the year by the reversal of the 1965 reduction in personal income taxes and by some of the other provisions of the March 1966 budget mentioned earlier, notably the reduc-

tion in depreciation allowances. While federal revenues in total were not greatly different from the forecasts made in the March budget, the growth in expenditures and new commitments for spending was considerably greater. Shortly after mid-year the Government indicated that revenue measures would have to be considered to meet the burden of a new programme of supplementary old age security payments. In December, when this programme received legislative approval, a supplementary budget was introduced in which specific measures were proposed for financing the programme; effective January 1, 1967, the maximum amount of tax payable by individuals under the Old Age Security Act was doubled and the manufacturers' sales tax was raised from 11 per cent to 12 per cent, except on machinery and building materials. In September the Government announced a one-year postponement until July 1, 1968 of the commencement of the proposed universal medical services programme.

On a national accounts basis, the federal government's expenditures in the calendar year 1966 rose $425 million more than its revenues (not including the net receipts in respect of the Canada Pension Plan or the refundable tax on corporations). In 1965, by contrast, its revenues had risen $275 million more than its expenditures. There was also an increase in 1966 of over $400 million in the federal government's net disbursements under the various lending programmes shown in the table on page 52.

Although some provinces increased sales and other taxes during the year, the combined national accounts deficit of provincial and municipal governments increased sharply and was about $150 million higher in 1966 than in 1965. A sizeable surplus was accumulated by the Canada and Quebec Pension Plans which collected over $700 million in the first year of contributions and made no pension payments; under the arrangements pertaining to the Plans, the net funds accumulated are used to finance the spending and lending activities of the provinces or their agencies.

FOREIGN TRADE. The increase in the level of activity in the domestic economy in 1966 was not accompanied by a deterioration in the merchandise trade balance. Demand in foreign markets was buoyant and Canadian exports rose by 17 per cent, compared with 6 per cent in 1965. Merchandise imports rose by 15 per cent in 1966, about the same rate as in the previous year. The trade surplus, which had reached a post-war peak of $700 million in 1964 and then declined sharply to about $120 million in 1965, rose to $380 million in 1966. Higher export prices contributed to the increase in the value of exports in 1966; after rising by a little more than one per cent in 1964 and 1965 export prices went up by about 4 per cent in 1966. Import prices, on the other hand, which

had shown little or no increase in the two previous years, rose by 1½ to 2 per cent.

Two special factors affecting trade in 1966 should be borne in mind in comparing the 1966 increase in merchandise exports and imports with earlier years. First, following the signing of the Canada-United States Automotive Agreement in January 1965 there was a large increase in two-way trade in new parts and completed automobiles and trucks. This is shown in the figures in the table below; the table also shows a reduction in 1966 in the very large deficit in trade in automotive products following a considerable widening in the deficit in 1964 and 1965. It may be noted that in 1966 this net balance of imports of automotive products still supplied more than one quarter of the Canadian market for new automobiles and trucks.

The second special feature relates to exports of wheat and flour. Shipments to the Soviet Union under large bulk contracts and sales to other markets fell off in 1965 and again rose sharply in 1966. Part of the 1966 increase in wheat exports was in shipments to India under the bilateral food aid programme. Through much of the period after mid-1965 the volume of wheat shipments was pressing on the limits of the available transportation and handling facilities.

MERCHANDISE TRADE(1)

(millions of dollars)

	1963	1964	1965	1966(2)
Automotive products				
Exports	100	190	366	969
Imports	698	849	1,168	1,647
Balance	−598	−659	−802	−678
Wheat and flour				
Exports	881	1,093	921	1,155
All other commodities				
Exports	6,101	6,955	7,458	8,146
Imports	5,881	6,688	7,459	8,243
Balance	220	267	− 1	− 97
Total				
Exports	7,082	8,238	8,745	10,270
Imports	6,579	7,537	8,627	9,890
Balance	503	701	118	380

(1) Adjusted to balance of payments basis.
(2) Data for automotive products and for all other commodities are preliminary estimates.

The balance of trade in commodities other than wheat and flour and automotive products has worsened in the past two years, moving from a surplus of $267 million in 1964 to approximate balance in 1965 and a deficit of $97 million in 1966.

Exports of commodities other than wheat and flour and automotive products rose by about 9 per cent in 1966 compared with an increase of 7 per cent in 1965. Much of the increase in 1966 was in exports to the United States which rose by about 13 per cent. Canadian exporters benefited from strong United States demand for most non-ferrous metals, newsprint and other forest products, and a wide range of manufactured products, especially machinery and electrical apparatus. Canada's total exports to the United States increased more rapidly than total United States imports but all of the gain in Canada's share of United States imports was concentrated in automotive products; Canada's share of other United States imports declined.

The economic conditions in the major overseas markets described earlier in this Report influenced the pattern of Canadian exports. Shipments of commodities other than wheat to Continental Europe and Japan reflected the rising demands in these markets; Canada's share of total imports into these areas expanded. Shipments to Britain, on the other hand, declined even though Britain's total imports rose slightly, so that Canada's share of that market fell. There was little or no increase in Canada's exports of commodities other than wheat to all other market areas in 1966 though total imports into these regions expanded.

CANADIAN EXPORTS EXCLUDING WHEAT AND FLOUR(1)

	Value (millions of dollars) 1965	1966 (11 months)
To: United States		
automotive products	194	719
other commodities	4,195	4,758
Sub-total	4,389	5,477
Britain	924	892
Continental Europe	656	715
Japan	199	271
Australia, New Zealand, South Africa	234	204
All other countries(2)	504	517
Total	6,906	8,076

(1) Trade of Canada basis, excludes re-exports.
(2) Mainly less developed countries; also includes Eastern Europe.

Canadian merchandise imports other than automotive products rose by nearly 11 per cent in 1966, almost the same rate of increase as in 1965. This reflected continued strong demand for a wide range of imported machinery and other investment goods and consumer goods. Imports of other transportation equipment continued to rise but imports of construction materials, notably structural steel, declined. Imports of automotive products rose by about 40 per cent.

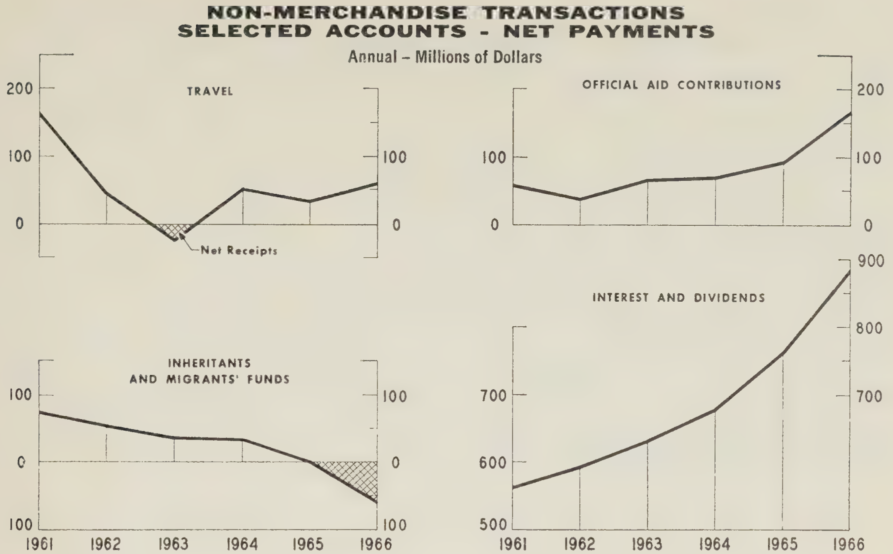
Almost all of the increase in total imports which occurred during the course of 1966 was concentrated in the second half of the year. This reflected the strongly rising trend in imports of automotive products and increased deliveries towards the end of the year of investment goods ordered from the United States.

CANADIAN IMPORTS CLASSIFIED BY END-USE(1)

	Value (millions of dollars)		Percentage change from previous year	
	1965	1966 (11 months)	1965	1966(2)
Fuels and lubricants	570	577	15	1
Industrial materials	2,102	2,280	11	8
Producers' equipment	1,980	2,336	14	18
Construction materials	287	276	14	− 4
Transportation equipment(3)	260	303	44	17
Food	621	648	− 4	4
Other consumer goods	743	837	12	13
Special items	248	301	25	21
Sub-total	6,809	7,558	12	11
Automotive products	1,035	1,447	38	40
Total	7,844	9,006	15	15

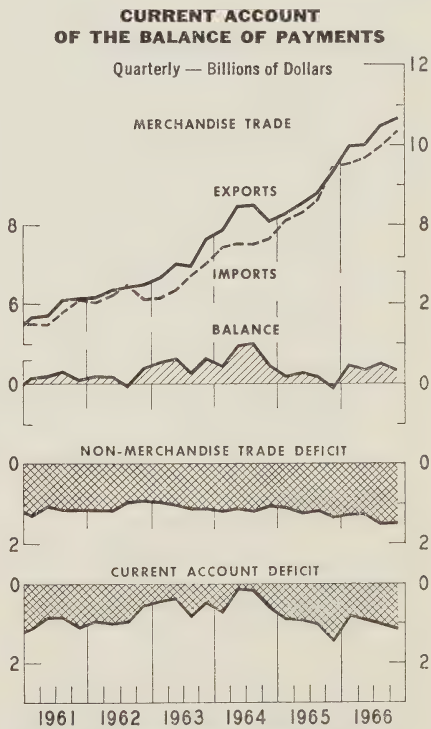
(1) Trade of Canada basis.
(2) Change from first 11 months of 1965 to first 11 months of 1966.
(3) Excluding automotive products.

Canada's international deficit on non-merchandise transactions increased from $1,201 million in 1965 to $1,363 million in 1966. Larger deficits on interest and dividend account and in the form of official foreign aid contributions were offset only in part by an improvement in the balance of inheritances and



migrants' funds and an increase in receipts from foreign governments in connection with their outlays for the construction of pavilions at Expo '67. Most of the increase in foreign aid contributions took the form of wheat shipments to India which are included in merchandise exports.

Our total current account transactions with the rest of the world resulted in a deficit of $983 million in 1966 compared with a deficit of $1,083 million in 1965 and $424 million in 1964. The current account deficit with the United States rose slightly in 1966 to a new peak of $2,100 million*. As a result of larger wheat exports the surplus with other countries rose again to a higher level than in any previous year in more than a decade except 1964.



Balance of payments basis; seasonally adjusted at annual rates.

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* Excluding gold production available for export.

PRODUCTION. The developments which have been described in domestic and foreign demands on the economy naturally had their counterpart in patterns of output in 1966. Production was also significantly affected by industrial disputes, particularly during the third quarter of the year when the number of man-days lost through strikes was as great as in the whole of 1965. Partly for this reason, industrial production dipped during the summer; in subsequent months it showed fairly sizeable gains but the underlying trend after the first quarter of the year reflected more moderate rates of growth than had prevailed during the first five years of the expansion. Automobile and steel production levelled out in 1966 and declined towards year-end. The decline in housing activity in North America led to a reduction of output in the lumber, forestry and construction industries in the latter part of the year. Non-residential construction activity also eased somewhat in the second half of the year. There was, however, continued rapid growth in the output of services, including trade, transportation, finance and public services.

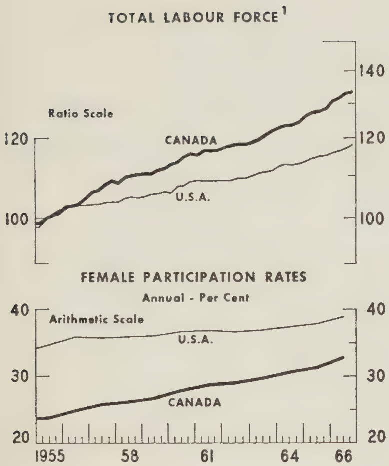
EMPLOYMENT. An outstanding feature of the year was the extraordinary increase of nearly 4 per cent in the labour force on an annual average basis. This was about one per cent more than the increase in 1965 and was larger than in any other year on record except 1957 when the increase was also about 4 per cent. In 1966 as in 1957 immigration was a major factor. Total immigration rose from under 150,000 in 1965 to almost 200,000 in 1966. However, this factor was less important than in 1957 when there were over 280,000 immigrants, an unusually high proportion of whom were destined for the labour force. Another major factor contributing to the growth of the labour force in 1966 was the further strong rise in the proportion of the female population, particularly married women, holding jobs. The female labour force increased by 7½ per cent in 1966 compared with about 5½ per cent in 1965. In 1966 roughly one third of the number of women of labour force age (14 and over) were in the labour force compared with approximately one quarter a decade earlier. The female participation rate in Canada in 1966 was still considerably below that in the United States, but over the past decade the gap has narrowed from about 11 per cent to about 6 per cent. This appears to reflect changing attitudes in Canada as well as the magnetic pull of job opportunities. The Canadian male labour force rose by about 2½ per cent in 1966 compared with just over 2 per cent in the previous year; most of this change appears to have been associated with the increase in immigration.

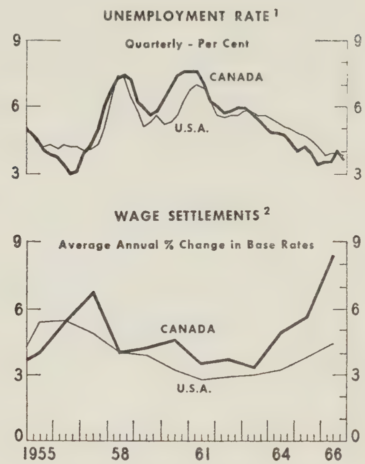
As mentioned previously, non-farm employment registered an even larger increase in 1966 than in the previous year—5.4 per cent on an annual average basis compared with 4.8 per cent in 1965. Following a decline of 5½ per cent

SELECTED COMPARISONS
CANADA - U.S.A.

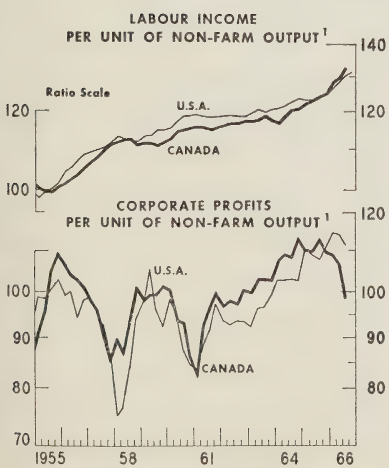
Quarterly — Index 1955 = 100 (Unless Otherwise Noted)

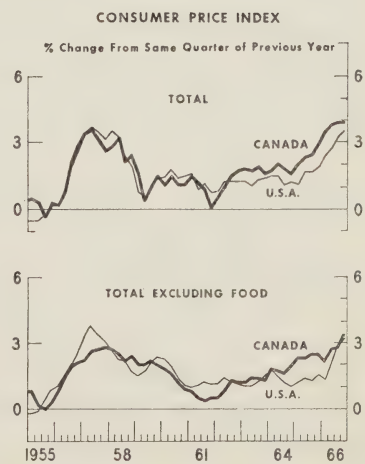
LABOUR MARKETS





COSTS, PROFITS AND PRICES

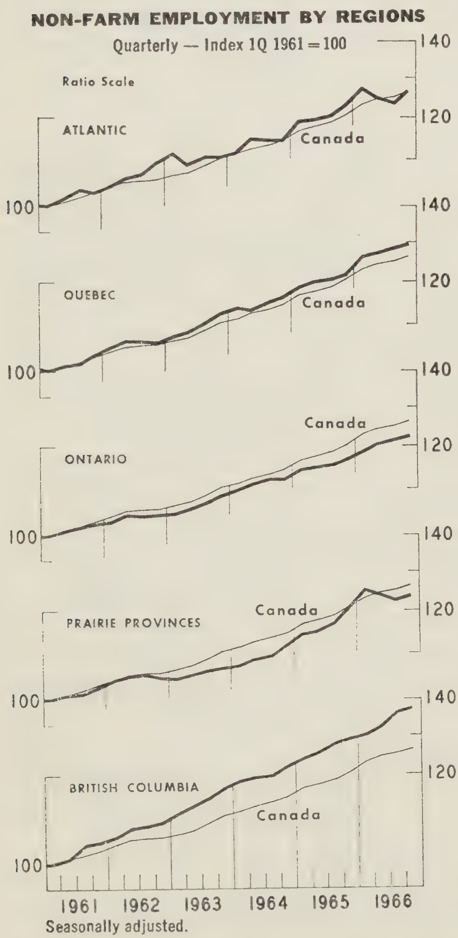




1. Seasonally adjusted.
2. Increases provided by larger collective agreements signed during year with principal exception of those in construction; based on figures of Department of Labour (Canada) and Department of Labor (U.S.A.).

in 1965, farm employment fell by a further 8½ per cent in 1966. In the last two years there has been a marked acceleration in the long-term downward drift of farm employment. In part at least the faster decline in farm employment in the past two years is another indication of the pressure of demand elsewhere in the labour market. Over the past decade, while agricultural production has continued to rise, farm employment has declined by roughly one third. Agriculture now accounts for 7½ per cent of total employment.

Total employment in the economy as a whole averaged just over 4 per cent higher in 1966 than in 1965. Male employment grew by about 3 per cent and female employment by almost 7½ per cent in 1966. There was little change in unemployment; the average annual unemployment rate declined slightly further from 3.9 per cent in 1965 to 3.6 per cent in 1966, but the unemployment rate was about the same at the end of 1966 as at the end of 1965.



Despite some unevenness, all the main regions of the country registered further strong increases in non-farm employment in 1966, with Quebec and the Prairies showing gains well above the national average. All regions except British Columbia also shared in the drop in farm employment. The growth of the labour force was highest in British Columbia, and was also above the national average in Quebec and Ontario; it was lowest in the Prairies and the Atlantic Provinces. Unemployment rates declined further in all regions except British Columbia though the decline in Ontario was marginal. In British Columbia the unemployment rate rose from an average of 4.2 per cent in 1965 to 4.5 per cent in 1966; in part this appears to reflect the impact on British Columbia's forest industries of the decline in housing activity in North America, but it may be noted that the British Columbia labour force rose by the extraordinarily large figure of over 6½ per cent in 1966.

REGIONAL LABOUR MARKETS - 1966

	Labour force	Employment			Unemployment rates	
		Farm	Non-farm	Total	Annual	4th quarter(1)
		(annual percentage change from 1965)			(per cent of labour force)	
Atlantic............	2.5	− 5.9	3.9	3.5	6.4	6.2
Quebec............	4.6	− 8.6	6.3	5.4	4.7	4.5
Ontario............	4.0	− 7.3	4.7	4.0	2.5	2.5
Prairies............	1.6	−11.4	6.2	2.2	2.1	2.2
B.C................	6.6	+13.6	5.7	6.1	4.5	4.9
Canada............	3.9	− 8.4	5.4	4.2	3.6	3.6

(1) Seasonally adjusted.

COSTS AND PRICES. Upward pressures on costs and prices, which had already emerged by the end of 1965, became clearly visible during 1966. Tight labour market conditions coincided with an unusually large number of wage contract negotiations. Stimulated by the size of some earlier wage and salary settlements in construction and elsewhere, by rising prices—particularly for food—and in some cases by profit levels, large wage demands were pressed vigorously and successfully in most sectors of the economy. In the majority of cases, settlements included large increases for current and subsequent years. As the chart on page 35 shows, the average annual increase in wage rates provided for by settlements in 1966 exceeded the increase for prior years in Canada and was very substantially above the scale of 1966 settlements in the United States. It appears that wages and salaries in important areas not covered by formal collective bargaining arrangements were also subject to strong upward pressures. Although many of the adjustments which occurred were not yet wholly reflected in earnings for the calendar year, labour income per worker (including self-employed workers) in the non-farm economy was almost 7 per cent greater in 1966 than in 1965; this compared with an increase of about 6 per cent in1965.

The average increase in wages and salaries in 1966 considerably exceeded the long-run average rate of growth in productivity and surpassed by an even wider margin the productivity improvement actually achieved during the year. As the table on the next page shows, the increase in output per worker in the non-farm economy in 1966 appears, on the basis of presently available data, to have been about half the relatively modest gain of 1965. In manufacturing, where productivity measures are generally considered to be somewhat more precise, a marked slowdown in the rate of productivity improvement was also evident. Consequently, the increases in wage and salary costs per unit of output in most sectors of activity in 1966 were much greater than the 1965 increases to which attention was drawn in last year's Report.

EARNINGS AND OUTPUT

(percentage change from previous year)

	Canada				United States
	1963	1964	1965	1966(3)	1966(3)
Wages and salaries per worker					
Non-farm(1)	3.5	4.1	6.0	6.9	6.4
Manufacturing(2)	2.4	3.8	5.2	5.9	4.0
Output per worker					
Non-farm(1)	2.4	2.8	2.2	1.1	2.5
Manufacturing(2)	3.3	4.1	3.6	2.2	3.4
Wages and salaries per unit of output					
Non-farm(1)	1.1	1.2	3.7	5.8	3.8
Manufacturing(2)	−0.9	−0.4	1.6	3.6	0.6
Corporate profits per unit of output					
Non-farm	4.2	7.4	0.9	−5.9	3.8
Manufacturing	5.2	−0.5	−1.8	−8.9	−0.2

(1) Wages and salaries include military pay and supplementary labour income; employment based on labour force survey (including self-employed) and armed forces enrolment.

(2) Wages and salaries do not include supplementary labour income; employment based on all-establishment survey which differs somewhat from measure used by DBS in official productivity estimates, so far available only annually to 1965.

(3) Change from first 9 months of 1965 to first 9 months of 1966.

The 1966 increases in wage and salary costs per unit of output in Canada were also considerably greater than in the United States. For the non-farm economy as a whole, this appears to have reflected mainly the poor productivity performance in Canada. However, in manufacturing—the sector most directly relevant to Canada's international competitive position—the sharper rise in unit labour costs in Canada resulted from both a smaller gain in productivity and a larger increase in average wages and salaries than in the United States.

There was a strong tendency for profits as well as prices to feel the impact of rising costs in Canada in 1966. In 1965 the ratio of total corporate profits to output had levelled out. This ratio declined markedly in 1966, particularly in the third quarter when strikes had an appreciable impact on profits. As may be seen in the chart on page 35 and in the table above, this reduction in profit margins in Canada in 1966 was in contrast to the situation in the United States, though there too some decline in profit margins in manufacturing developed in the course of the year.

Prices in Canada rose more rapidly in 1966 than in 1965. Food prices, which had gone up sharply in 1965, continued to increase through most of 1966. Although the food component of the Consumer Price Index eased slightly towards the end of the year, the average level of food prices in the last quarter of

1966 was still almost 10 per cent higher than two years earlier. In the course of 1966 there was some tendency for meat prices, which had been the principal initial source of the upswing, to moderate but prices of a broad selection of other food items rose more rapidly. As the table below shows, the rate of increase of non-food prices was substantial in 1966. The prices of goods other than food rose more than twice as much in 1966 as they did in 1965; some part of this acceleration was related to sales tax increases. Durable goods prices, which had been stable or declining for several years, increased by about one per cent in 1966. As the chart on page 35 and the table below show, the rate of increase in Canadian prices continued to exceed that of prices in the United States, though apparently by a narrower margin towards year-end.

PRICES

(percentage change from previous fourth quarter)

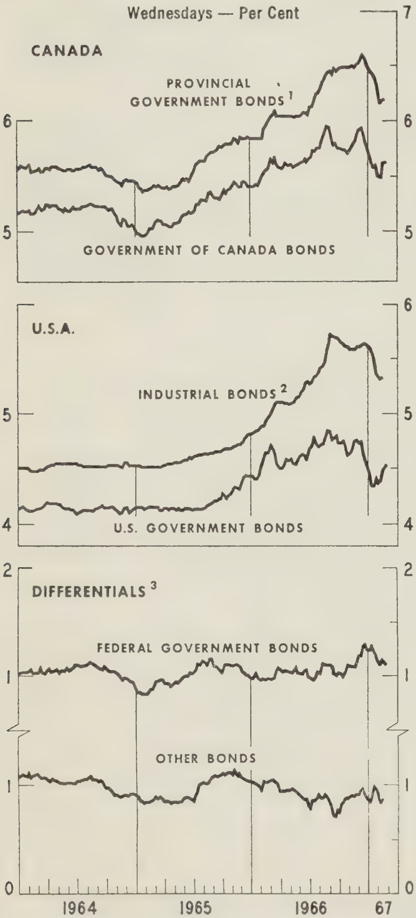
	Canada				United States
	4Q '63	4Q '64	4Q '65	4Q '66	4Q '66
Prices of all goods and services (GNP deflator)	1.7	2.8	3.1	4.7[1]	3.6
Consumer prices:					
Total CPI	1.6	1.6	2.9	3.9	3.5
Food	2.6	0.9	4.3	5.2	4.6
Total except food	1.3	1.9	2.5	3.4	3.2
Goods except food	0.8	0.8	1.2	2.8	2.1
Durables	–	−1.0	–	1.2	1.1
Non-durables	1.2	1.6	1.6	3.4	2.8
Services	1.4	3.0	4.2	3.7	4.8

(1) Change from 3Q '65 to 3Q '66.

Financial Developments in Canada

The tightening of conditions in Canadian financial markets which began in 1965 continued through most of 1966. Credit conditions also continued to tighten in the United States and Europe. Despite the slackening in the rate of economic growth which occurred in Canada in the course of 1966, the demand for credit remained very strong. Short-term interest rates rose considerably. Yields on long-term Government of Canada bonds reached a peak of about 6 per cent. Yields on other long-term securities rose somewhat more than on Government of Canada bonds. Access to mortgage credit became more difficult and by the fourth quarter of the year rates on prime conventional residential loans had risen to about 8 per cent. During the summer, when the upward pressures on interest rates in the United States became particularly severe, the Bank of Canada offered considerable resistance to a further tightening of credit conditions in Canada. The chartered banks' total assets, which had grown slowly in the first half of the year, were permitted to increase more rapidly in the second half; the banks were able to add significantly to their holdings of more liquid assets and indeed to increase the ratio of such assets to their total assets while accommodating an increased rate of loan expansion. By the end of the year interest rates were declining in Canada and abroad and the easing of credit conditions continued into early 1967.

LONG-TERM INTEREST RATE AVERAGES



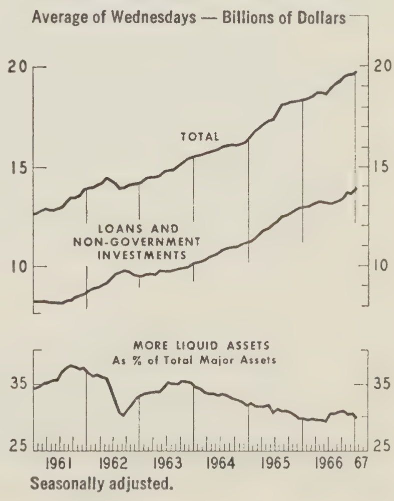
1. Average weekly yields on the 10 provincial bonds included in the monthly series published by McLeod, Young, Weir and Co. Ltd.
2. Average yield on industrial bonds published by Moody's Investor's Service Inc.
3. Rate in Canada minus rate in U.S.A.

Through the first quarter of 1966 it was evident that the pressure of demand on the economy was increasing rapidly and that our balance of payments on current account remained in substantial deficit. Interest rates were rising in the United States and Europe. On March 11 the Bank of Canada announced an increase in its Bank Rate from 4¾ per cent to 5¼ per cent, thus underlining the concern about inflationary dangers expressed in its Annual Report for 1965 which was made public on the same day. Over the first quarter of 1966 the yield on three-month treasury bills rose from 4.5 per cent to 5.1 per cent and the average yield on long-term Government of Canada bonds increased from 5.4 per cent to 5.6 per cent.

During the second quarter of the year there was little change in yields on Government of Canada securities, though some other interest rates continued to rise gradually. On occasion during this period the Bank of Canada resisted by its open-market operations a tendency for Government of Canada bond yields to decline. In addition, in connection with the May 1 Government of Canada refunding issue, the Bank repeated a technique first used at the time of the February 1 refunding and informed primary distributors of Government of Canada securities that it was prepared to purchase the new issues offered by the Government in exchange for certain longer-term bonds from its own portfolio. As a result of this offer the Bank sold $49 million of bonds maturing in 1988 and 1990, principally in exchange for the new 1980 maturity. Details of the Bank of Canada's securities transactions during 1966 are shown in Appendix Table I.

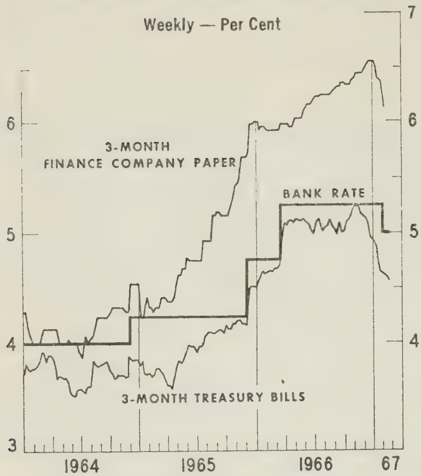
The growth of the chartered banks' Canadian assets slowed down to an annual rate of about 3 per cent in the first half of the year compared with 12 per cent in 1965. Even though total Canadian dollar bank loans rose at an annual rate of only 5 per cent during this period, compared with 20 per cent in 1965, the banks' more liquid asset ratio continued to decline. In the mortgage market, loan approvals by private institutions, which had fallen off in the second half of 1965, remained at a relatively low level and, with the demand for mortgage funds remaining strong, conventional mortgage rates rose further. The expansion of consumer credit granted by banks and other lenders slowed down significantly during the second quarter.

CHARTERED BANK ASSETS



Seasonally adjusted.

SHORT-TERM INTEREST RATES



By mid-year, as evidence accumulated that the growth of aggregate demand in the economy was moderating, the Bank of Canada began to offer resistance to a further tightening of credit conditions. It managed the cash reserves of the chartered banks in a way that permitted their total assets to expand more rapidly than earlier in the year. The banks were able to increase significantly their more liquid asset ratio at the same time as their loans began to expand more rapidly. The Bank's operations in Government of Canada securities, including its operations in treasury bills, were also directed towards restaining an increase in interest rates and the yield on 3-month treasury bills remained close to 5.1 per cent until October.

Sharp upward pressure on Government of Canada bond yields developed in August. A dramatic fall in bond prices in the United States, beginning at mid-month, complicated the task of refunding a large Government of Canada bond maturity of September 1, the terms of which were announced on August 15. The Bank took the view that it should resist an excessive increase in Canadian interest rates and in pursuance of this view it provided strong support for the bond market. In the week preceding the announcement of the new issue the Bank bought $3 million of longer-term Government of Canada bonds in the market. On the day of the offering and the day following, it purchased $58 million of bonds in the market. It also subscribed for substantially more of the new issues than the minimum of $175 million which it had committed itself to buy. In total, around the middle of August the Bank purchased or subscribed for $314 million of Government of Canada bonds; its holdings of bonds due to mature on September 1 were $115 million. Later in the month the Bank bought an additional $21 million of Government of Canada bonds in the market. Despite the strong action described, interest rates rose substantially and the average yield on long-term Government of Canada bonds reached a peak of 5.97 per cent late in the month.

At the end of August bond markets turned around and the yields on Government securities dropped in the United States and in Canada. To limit the extent of this reversal the Bank of Canada sold $55 million of Government of Canada bonds to the market early in September and further cash sales were made later in the month. Most of the effect on chartered bank cash reserves of the very sub-

stantial volume of bond purchases and subscriptions referred to was offset by reductions in the Bank of Canada's portfolio of treasury bills and by sales of foreign exchange to the Exchange Fund Account.*

The volume of new Canadian issues negotiated in the United States fell to a low level in the third quarter, and in September the value of the Canadian dollar in the exchange markets began to decline. The operations of the Bank late in September and during October were designed in part to ensure that the differential of bond yields between Canada and the United States was adequate. The Bank sold Government of Canada bonds for cash to the extent of $13 million net late in September and $16 million net in October. An additional $56 million of bonds, principally long-term issues, was sold in the market in exchange for short-term maturities.

Throughout October there was little change in the yields on Government of Canada securities while comparable yields declined in the United States. There was also some widening of average yield differentials on other securities. Yields in both countries rose in November, with Canadian yields moving up somewhat more rapidly and continuing to rise in December despite some market purchases of Government of Canada securities by the Bank of Canada. By the end of the year, however, interest rates in Canada and the United States had started to decline and the easing of conditions in financial markets continued in early 1967.

On January 30, 1967 the Bank of Canada reduced its Bank Rate from 5¼ per cent to 5 per cent. The average rate on three-month treasury bills at the weekly auction, which had been 5.20 per cent in mid-November, fell to 4.68 per cent at the last tender in January and was 4.58 per cent at the last tender in February. The average yield on long-term Government of Canada bonds, which had been 5.93 per cent early in December, fell to about 5½ per cent in the first week of February, and was 5.61 per cent at the end of that month.

Developments during August and September 1966 have been described in some detail above. They provide a striking example of a problem which arose a number of times in 1966 and early 1967 as a result of the fact that interest rates in the United States fluctuated a good deal more widely than in earlier years. This can be seen in the chart on page 40. For example, the average yield on long-term United States Government bonds rose from 4.41 per cent on January

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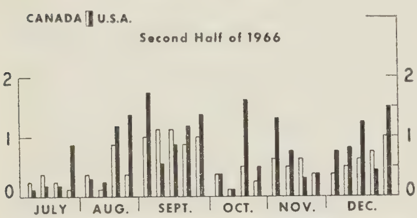
* The foreign exchange had previously been purchased on a temporary basis from the Exchange Fund Account at times when the Bank did not consider it desirable to provide for increases in the chartered banks' cash reserves by purchasing securities in the market. The Bank makes payments for such foreign exchange purchases by crediting Canadian dollars to the Receiver General's deposit account with it, and when these funds are redeposited to the credit of the Government's accounts with chartered banks, chartered bank cash reserves are increased. During 1966, the Bank of Canada made considerable use of transactions with the Exchange Fund Account to assist in the management of chartered bank cash reserves. These and other transactions in foreign currencies affect the Bank of Canada's net foreign asset position, monthly changes in which are shown in Appendix Table II.

21, 1966 to 4.70 per cent by February 28 and then fell to 4.53 per cent by March 23. This average yield increased from 4.73 per cent on August 12 to 4.91 per cent on August 29 and by September 9 had dropped back to 4.73 per cent. There was an increase from 4.59 per cent on October 25 to 4.75 per cent on November 18, a decline from 4.76 per cent on December 8 to 4.32 per cent on January 16, 1967, and an increase to 4.53 per cent at the end of February. Expectations in the Canadian bond market were considerably affected by these swings and the Bank of Canada had of course to take account of their influence on the development of credit conditions in Canada and on our international capital flows.

WEEKLY FLUCTUATION OF BOND PRICES[1]
CANADA AND U.S.A.
Price Range in Dollars



1. The bars show the weekly range between high and low closing bid quotations on the Government of Canada 5¼ per cent bonds due on May 1, 1990 and the U.S. Government 4¼ per cent bonds due on August 15, 1992.

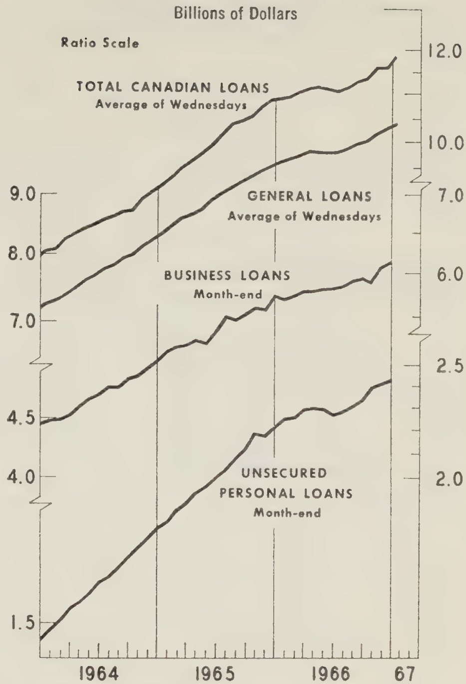
The greater volatility of the United States securities market also involved unusually wide day-to-day changes in prices and yields. The accompanying chart shows, for the second half of 1966, the weekly variations in the price of a typical long-term federal government bond in the United States and in Canada. The volatility in the United States market was considerably greater than had earlier been the case and much greater than in the Canadian market.

CHARTERED BANKS AND OTHER FINANCIAL INSTITUTIONS. The total of the chartered banks' Canadian assets, which had increased by 12 per cent in 1965, rose at an annual rate of 3 per cent in the first half of 1966 and 10 per cent in the second half. During the second half of the year, when total Canadian dollar loans were rising at an annual rate of 9 per cent (about double the rate of increase in the first half of the year), the banks were also able to increase their more liquid asset ratio. Both business loans and personal loans increased slowly over the first half-year, the outstanding amount of unsecured personal loans actually declining during the second quarter when the banks were under severe pressure. After mid-year both business loans and personal loans began to expand more rapidly but the increases over the year as a whole were only half as large as the increases in 1965. Personal loans secured by marketable stocks and bonds declined fairly steadily throughout 1966. There were increases in other classes of loans except those to sales finance companies which had been particularly high in the second half of 1965 after the failure of Atlantic Acceptance Corporation. Loans to municipalities, which had risen

sharply in 1965 in anticipation of receipts from the Municipal Development and Loan Board, continued to increase in 1966. The banks' foreign currency credits to Canadian residents increased by $91 million in 1966 compared to $275 million in 1965.

The rise in interest rates and the slower growth of the chartered banks in 1966 was accompanied by a slower growth in the assets of most other types of financial institution; the total assets of one important group, the sales finance and consumer loan companies, fell slightly during the second quarter of 1966. Final information for December 1966 is not yet available, but the indications are that the trust, sales finance and consumer loan companies expanded more rapidly after mid-year, as did the banks.

CHARTERED BANK LOANS

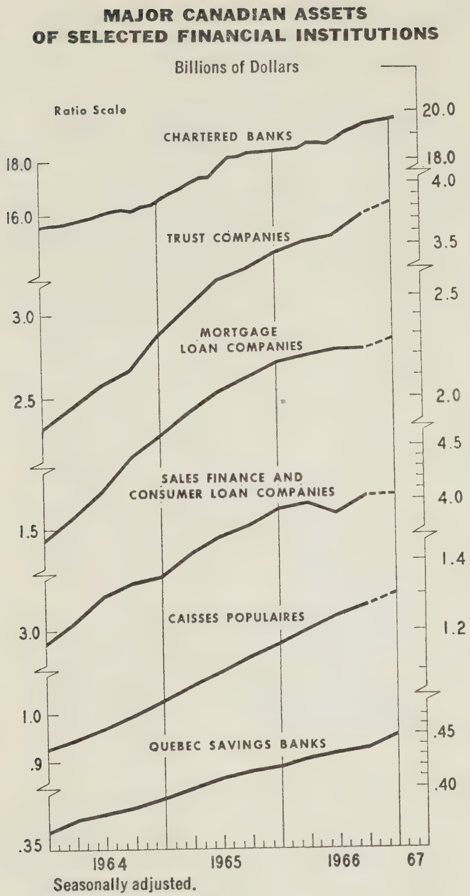


Seasonally adjusted.

MAJOR CANADIAN ASSETS OF SELECTED FINANCIAL INSTITUTIONS[1]

	Billions of dollars Dec. 1966	Percentage increase at annual rates				
		Dec. 1960 to Dec. 1964	1965		1966	
			First half	Second half	First half	Second half
			seasonally adjusted			
Chartered banks	19.7	7	12	11	3	10
Other						
Quebec savings banks	.4	7	8	5	7	8
Trust companies	3.7e	22	26	12	7	15e
Mortgage loan companies	2.3e	20	20	13	6	5e
Sales finance and consumer loan companies	4.0e	11	18	12	−2	8e
Caisses Populaires Desjardins de Québec	1.3e	11	13	13	13	11e
Sub-total	11.7e	15	20	12	4	10e
Total	31.4e	9	15	12	3	10e

e: Estimate.
(1) The figures include all Canadian assets except fixed assets, investments in subsidiary or affiliated companies and sundries. Relatively small net amounts of assets in foreign currencies are also included in some cases.



The slower growth of financial institutions reflected the difficulty they encountered in raising funds at costs which would leave them an adequate profit inducement to expand their business. By the same token, their inability to expand more rapidly was an important aspect of the increasing difficulty faced by individuals and smaller business borrowers who normally obtain their loan funds through such financial intermediaries. Mortgage borrowers found conditions particularly difficult. Other borrowers such as larger businesses, governments and their enterprises were more successful in obtaining financing since they were able to raise funds directly from the public and from non-residents by sales of securities, albeit at high rates of interest. This pattern of developments is characteristic of periods in which credit conditions are tightening and short-term interest rates are high relative to long-term rates.

The table on the opposite page shows changes in recent years in the main types of liquid financial asset held by the public. From the first group of items in the table it can be seen that the public's holdings of chequable deposits and other highly liquid claims grew less rapidly in 1966 than in preceding years. There was no increase in the rate of interest offered on chartered bank personal savings deposits, on the comparable Quebec savings banks' deposits, or in the rates paid by most trust and mortgage loan companies on their savings accounts. With interest rates on most other types of liquid asset rising quite rapidly, the rate of accumulation of these liquid claims on banks and other institutions declined. Chartered bank demand deposits, however, increased at an annual rate of 13 per cent in the second half of 1966, and over the year as a whole the increase was 9 per cent compared to about 6 per cent in the two preceding

years. It is possible that the relatively large increase in 1966 resulted in part from an increase in the current balances held with chartered banks as compensation for services provided to customers.

GENERAL PUBLIC HOLDINGS OF CERTAIN FINANCIAL ASSETS(1)

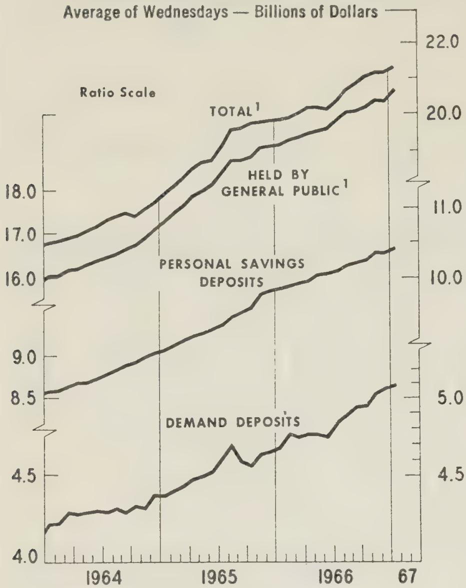
(millions of dollars)

	As at December			Percentage change		
	1964	1965	1966	1964	1965	1966
Currency	2,183	2,351	2,495	6.2	7.7	6.1
Chartered bank demand deposits	4,510	4,779	5,194	6.3	6.0	8.7
Chartered bank personal savings deposits	8,846	9,642	10,140	5.9	9.0	5.2
Quebec savings bank deposits	376	402	421	8.4	6.9	4.7
Caisses Populaires Desjardins de Québec deposits	910	1,028	1,140e	10.3	13.0	10.9e
Trust and mortgage loan company demand certificates and deposits	1,378	1,485	1,475e	27.7	7.8	−0.7e
Sub-total	18,203	19,687	20,865e	7.7	8.2	6.0e
Chartered bank						
— non-personal term and notice deposits	1,494	2,303	2,480			
— foreign currency deposits of residents						
— swapped	718	549	742			
— other	606	669	889			
Finance company short-term paper held by residents	600	550	630			
Other commercial paper held by residents	275	165	180			
Provincial and municipal short-term paper	160e	250e	316e			
Bankers' acceptances	11	150	170			
Government of Canada						
— Treasury bills	332	157	170			
— Market bonds of maturity under 3 years	1,402	1,441	1,480			
— Canada savings bonds	5,613	5,866	6,089			
Trust company investment certificates	1,535	1,973	2,375e			
Mortgage loan company debentures	981	1,085	1,200e			
Total	31,930	34,845	37,586e	8.7	9.1	7.9e

e: Estimate.

(1) This table includes relatively small amounts of some items held by non-residents.

CURRENCY AND CHARTERED BANK CANADIAN DOLLAR DEPOSITS

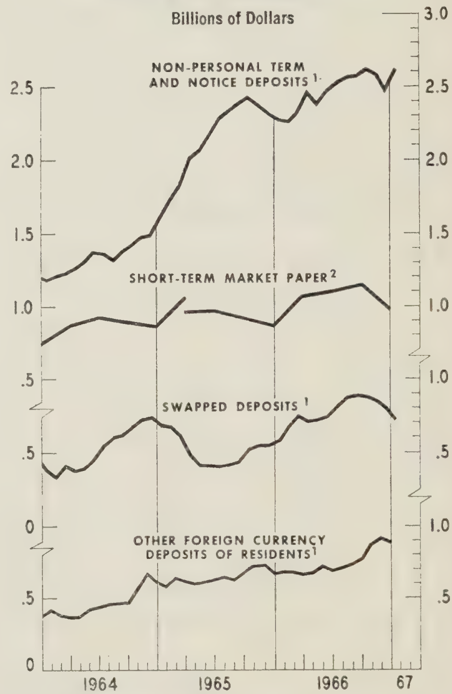


Seasonally adjusted.
1. Includes non-personal term and notice deposits shown in the following chart.

In the course of 1966 the yields available on U.S. dollar deposits placed by the chartered banks with prime banks in the United Kingdom and Europe reached a peak of about 7 per cent and money market rates in New York also rose to high levels. The attractive yields on short-term investments abroad enabled the chartered banks to offer high rates to Canadians on foreign currency deposits, and the total amount of these balances — swapped deposits and other foreign currency balances—reached a peak of $1,750 million in October. While there was some decline thereafter as short-term interest rates on U.S. dollar investments came down, these deposits rose by $413 million or 34 per cent over 1966 as a whole.

The chartered banks' Canadian dollar non-personal term and notice deposits increased by only 8 per cent in 1966 compared to an increase of about 75 per cent from the third quarter of 1964 to the third quarter of 1965 when these deposits provided higher rates of return than competing instruments. Although the banks continued to offer relatively high rates on large Canadian dollar term deposits in 1966, more attractive returns were available to the public through much of the year on some other short-term investments, including foreign currency deposits held with the banks.

SELECTED SHORT-TERM ASSETS HELD BY RESIDENTS



1. At chartered banks.
2. Short-term paper issued by finance companies and other commercial borrowers, and bankers' acceptances
Break in series reflects change in composition.

In December 1966 the total of currency and chartered bank Canadian dollar deposits was 6.7 per cent higher than a year earlier compared with an increase of 11.9 per cent in 1965. The amount held by the general public, i.e., exclusive of Government of Canada deposits, increased by 6.5 per cent compared with 12.0 per cent in 1965. Including foreign currency deposits of residents, the increase in general public holdings of currency and chartered bank deposits was 8.1 per cent compared with 10.6 per cent in 1965. In the case of all these series the increases were more rapid in the second half of 1966 than in the first half of the year.

Resident holdings of short-term paper issued by finance companies, other commercial borrowers and provinces and municipalities increased by about $160 million in 1966. The amount of bankers' acceptances outstanding increased by $20 million. Trust and mortgage loan companies continued to raise the interest rates on term certificates and debentures and as a result were able to attract a substantial flow of funds. There was also some increase in public holdings of short-term Government of Canada market securities and a large increase in the amount of Canada Savings Bonds outstanding as a result of the successful sale of the Centennial Series.

OTHER CAPITAL MARKET DEVELOPMENTS. The tightening of credit conditions in 1966 was particularly severe in mortgage markets. Life insurance companies, trust and mortgage loan companies and other private lending institutions had been approving new loans at an abnormally high rate in early 1965 and they sharply reduced the rate of approval of new mortgages in the second half of 1965 and during 1966. In the year and a half beginning mid-1965 the amount of mortgages approved by the private institutions was 27 per cent lower

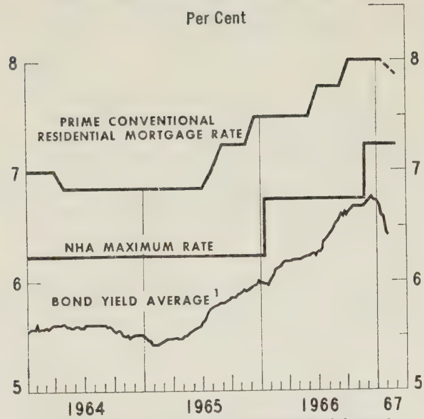
MORTGAGE LOAN APPROVALS

(millions of dollars)

	Private lending institutions					
	Conventional mortgages					
	Non-residential	Residential: Existing	Residential: New	Guaranteed under NHA	CMHC	Total
1964-First half.......	231	295	375	182	79	1,162
Second half....	276	345	437	170	297	1,525
1965-First half.......	338	436	470	186	86	1,516
Second half....	243	313	432	135	375	1,498
1966-First half.......	217	281	346	132	135	1,111
Second half....	170[e]	190[e]	225[e]	59	410	1,054[e]

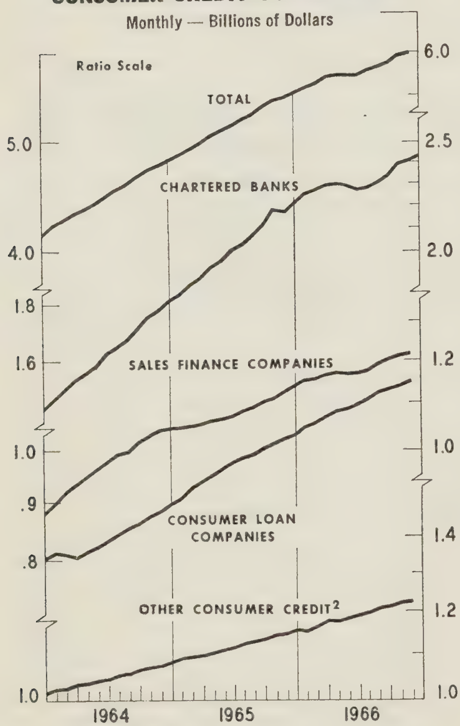
e: Estimate.

LONG-TERM INTEREST RATES



1. Average weekly yields on the 40 provincial, municipal, public utility and industrial bonds included in the monthly series published by McLeod, Young, Weir and Co. Ltd.

CONSUMER CREDIT OUTSTANDING[1]



Seasonally adjusted.
1. Balances for which monthly statistics are available.
2. Credit granted by Quebec savings banks, life insurance companies and monthly reporting retail dealers.

than in the preceding eighteen months. Private lending under the National Housing Act to finance the construction of new single-family housing fell particularly sharply, but Central Mortgage and Housing Corporation undertook an expanded direct lending programme which led to an increase in total NHA lending in 1965 and limited the decline in 1966 to 6 per cent. The brunt of tighter conditions in the mortgage market fell on the financing of new apartments and row housing, new non-residential properties and existing residential properties.

The reduction in the supply of mortgage funds led, in the face of strong demands, to increases in conventional mortgage rates. Prime rates, which had been below 7 per cent until mid-1965, rose to about 7½ per cent by the end of 1965, and to about 8 per cent by the last quarter of 1966. Early in 1967 some institutions reduced their prime lending rate to 7¾ per cent. The maximum rate on loans insured under the National Housing Act was increased from 6¼ per cent to 6¾ per cent on January 10, 1966. There was a brief recovery of private NHA lending but as the rates of interest available to the institutions on conventional mortgages and on bonds continued to rise, NHA loans again became relatively unattractive. On November 22 the maximum rate was increased to 7¼ per cent and it was announced that starting in April 1967 the maximum rate for each quarter would be set one and one-half per cent above the average yield

on long-term Government of Canada bonds on the four Wednesdays preceding the first day of the quarter, rounded to the nearest quarter per cent.

In the first half of 1966, as may be seen in the chart on the previous page, chartered banks and sales finance companies cut back their consumer lending and in consequence the rate of increase in total consumer credit outstanding was sharply reduced. There was resumed growth after mid-year, particularly in lending by the chartered banks, but over the year as a whole the rate of increase in consumer credit outstanding was well below that of 1965. The statistics on consumer credit do not include borrowing for consumption purposes on the security of residential mortgages: this must also have been reduced in 1966 as a result of the tightening of the mortgage market.

Attention was drawn on page 26 to the increase in capital expenditures by business in 1966. The cash flow available from retained earnings and depreciation allowances was very little larger than in 1965 and the external financing required by business increased from about \$2 billion in 1965 to \$2¾ billion in 1966. The following table shows that while external financial requirements were increasing, the total amount raised by non-financial businesses from their major sources of funds fell substantially. While businesses were able to maintain—though at progressively higher costs—the aggregate level of their financing through bonds, stocks and commercial paper placed directly in financial markets, their borrowing from financial intermediaries such as banks, finance companies

MAJOR SOURCES OF NON-FINANCIAL CORPORATE BUSINESS FINANCING

(millions of dollars)

	1965	1966
Increases in:		
Chartered bank loans in Canadian dollars	655	393
Chartered bank loans and securities in foreign currencies	275	91
Sales finance company loans	307	−150[e]
Other term loans	50	70
Non-residential mortgages	400[e]	300[e]
Sub-total	1,687	704
Net new issues of:		
Commercial paper and bankers' acceptances	32	61
Bonds	950	773
Stocks	333	444
Net direct investment from abroad	280	670
Sub-total	1,595	1,948
Total	3,282	2,652

e: Estimate.

and mortgage lenders was much lower than in 1965. The total raised from all the sources shown in the preceding table was significantly less in 1966 than in 1965 and less than the apparent need for financing. Businesses had been steadily accumulating financial assets from 1962 to 1965 and must have run down their holdings of liquid assets appreciably during 1966 in order to finance their investment programmes. This pattern of business financing implies that smaller firms, most of which rely on borrowing from financial intermediaries, were affected more severely than many large firms by the tight conditions in financial markets during 1966.

The Government of Canada's financial accounts are shown in Appendix Table III. In 1966 the Government of Canada's net revenue and expenditure position on the national accounts basis is estimated to have weakened by about \$425 million. In addition to the revenues included in that calculation, \$134 million was collected from the special refundable tax on corporate cash profits introduced in March and contributions to the Canada Pension Plan amounted to \$528 million. However, the proceeds of the refundable tax are set aside for

GOVERNMENT OF CANADA:
INCREASES IN MAJOR LOANS AND ADVANCES

(millions of dollars)

	1964	1965	1966
Central Mortgage and Housing Corporation(1)	203	276	456
Farm Credit Corporation	89	145	167
Municipal Development and Loan Board(1)	3	74	139
Veterans' Land Act	14	20	51
Sub-total	309	515	813
1967 World Exhibition	–	22	115
CNR (excluding advances to cover income deficits and refunding of debt)	31	25	17
Atomic Energy of Canada	– 3	14	11
National Harbours Board	2	2	17
Atlantic provinces power development	3	4	31
Loans to manufacturers re Canada-United States Automotive Agreement	–	–	11
Export Credits Insurance Corporation	33	50	38
Loans to foreign governments	– 7	10	7
Total	368	642	1,060

(1) Net of the 25 per cent share of advances to municipalities which is eligible for forgiveness of repayment and which is treated as federal expenditure in the year the advance is made.

subsequent repayment to corporations and the bulk of Canada Pension Plan contributions were re-loaned to provinces under the arrangements for the Plan. In addition to the weakening in the national accounts position, there was an increase of $418 million in the amount needed in 1966 to finance various governmental lending activities and for the other purposes indicated in the table on the preceding page.

In 1966 the net amount of Canadian dollars required for purposes unrelated to foreign exchange transactions and transactions with the International Monetary Fund was $692 million. In 1965 the comparable transactions provided net receipts of $92 million. In 1966 the group of transactions in foreign exchange and with the International Monetary Fund produced a net amount of $441 million. The amount of Government of Canada Canadian dollar securities outside Government accounts increased by $301 million and the Government's Canadian dollar cash balances increased by $50 million.

There was virtually no change in Bank of Canada holdings of Government of Canada Canadian dollar securities; those of the chartered banks increased by $167 million and those held by the general public increased by $132 million. General public holdings of Canada Savings Bonds increased by $222 million, while there was a reduction of $90 million in their holdings of Government of Canada Canadian dollar market securities. There was a reduction of $163 million in the amount of Government of Canada debt payable in U.S. dollars held outside Government accounts; $157 million of this reduction represented repatriations by the Government in connection with its management of the official foreign exchange reserves.

Expenditures by provincial and municipal governments rose more rapidly than their revenues in 1966 and in addition provincial and municipal enterprises, particularly hydro-electric commissions, carried out major capital investment programmes. As a result, this sector's financial requirements were considerably larger than in 1965. There was a decrease of $52 million in the aggregate amount borrowed from chartered banks, the Central Mortgage and Housing Corporation and the Municipal Development and Loan Board and by the sale of short-term paper, but other borrowings rose substantially. In particular, the establishment of the Canada and Quebec Pension Plans provided a very large new source of funds. $462 million was made available to the provinces other than Quebec through investment by the Canada Pension Plan Investment Fund in specially issued provincial bonds. In the case of Quebec it is believed that a substantial part of the Quebec Pension Plan receipts of about $170 million was invested in the market through the Quebec Deposit and Investment Fund in direct and guaranteed securities of the province and its municipalities.

SELECTED SOURCES OF FINANCING OF PROVINCIAL AND MUNICIPAL GOVERNMENTS AND THEIR ENTERPRISES

(millions of dollars)

	1964	1965	1966
Increases in:			
Chartered bank loans.	48	230	137
Loans by Central Mortgage and Housing Corporation and the Municipal Development and Loan Board(1)	33	101	166
Short-term paper outstanding	— 70	90	66
Receipts of Quebec Pension Plan	–	–	170e
Net new issues of bonds:			
Provincial bonds sold to Canada Pension Plan Investment Fund	–	–	462
Other provincial and municipal bonds	1,348	943	1,264
Total(2)	1,359	1,364	2,265

e: Estimate.

(1) Net of the 25 per cent share of advances which is eligible for forgiveness of repayment and which is treated as municipal revenue in the year the advance is made.

(2) To the extent that provincial government accounts and the Quebec Deposit and Investment Fund purchase provincial or municipal bonds at the time of issue or in the market, the total of the selected sources of financing includes double-counting and is thus overstated. In 1966 a substantial part of the Quebec Pension Plan receipts of about $170 million is believed to have been invested through the Quebec Deposit and Investment Fund in direct and guaranteed securities of the province and its municipalities. Purchases by the provincial accounts of other provinces are also believed to have been unusually large in the aggregate in 1966.

FINANCIAL TRANSACTIONS OF CANADIANS WITH NON-RESIDENTS. The net use of non-resident savings by Canadians declined from $1,083 million in 1965 to $983 million in 1966. Ordinary capital transactions in 1966 produced an inflow of $806 million, while special purchases of U.S.-pay bonds by the Government of Canada amounted to the equivalent of $182 million and official reserves declined by $359 million.

Details of the main transactions in the capital account are given in the table on page 56. It shows that the major types of long-term capital movements gave rise to a net capital inflow in 1966 appreciably larger than in 1965.

Deliveries of new issues of Canadian bonds sold to non-residents increased from $1,179 million in 1965 to $1,396 million in 1966. An official request made of Canadian borrowers in November 1965 to defer delivery of the proceeds of new issues already negotiated in the United States and to postpone any new United States borrowing until 1966 resulted in unusually large deliveries in the first quarter of the year. New offerings were substantial in the second quarter but declined after mid-year and did not pick up again until late in the year. Deliveries in the second half of the year were therefore relatively low.

NEW ISSUES OF CANADIAN BONDS SOLD TO UNITED STATES RESIDENTS

(millions of Canadian dollars)

	By date of offering	By date of delivery	Undelivered at end of period
1965			
1 Q	344	263	132
2 Q	282	311	103
3 Q	399	284	218
4 Q	391	291	318
1966			
1 Q	356	518	156
2 Q	386	348	194
3 Q	202	276	120
4 Q	198	203	115

Foreign direct investment in Canada rose sharply in 1966 to a near-record level of $660 million and there was a small net repatriation of funds from Canadian direct investment abroad in contrast to outflows of about $100 million in each of the past few years. United States direct investment in Canada rose in 1966 despite earlier fears that a United States balance of payments guideline limiting investment in industrial countries as a group might result in a cut-back in Canada. One of the objects of the United States balance of payments programme was to encourage United States companies to raise funds abroad for their international operations. If this had resulted in their attracting funds from Canada it would have put abnormal pressure on the Canadian capital market and could have forced Canadian borrowers to rely more heavily on the United States market. In March the Minister of Finance asked Canadian investors not to purchase "off-shore" securities of United States corporations, that is, the securities of United States corporations or their non-Canadian subsidiaries which would be subject to the United States Interest Equalization Tax if purchased by United States residents. After March there were no significant purchases of this type of securities by Canadians.

There was a sizeable reduction in capital outflows resulting from repurchases of outstanding Canadian stocks from non-residents in 1966. On the other hand there was a swing from an inflow to an outflow arising from transactions in outstanding Canadian bonds. There was also a very large increase in the outflow from Canadian purchases of foreign securities which rose from $84 million in 1965 to $332 million in 1966; most of this represented the purchase of outstanding United States equities from United States residents. Offerings of new issues of securities in Canada by foreign borrowers continued to be officially discouraged.

CANADIAN BALANCE OF INTERNATIONAL PAYMENTS

(millions of Canadian dollars)

			1966			
	1965	1966	1 Q	2 Q	3 Q	4 Q
Current Account Balance	−1,083	−983	−405	−330	116	−364
Capital Account Transactions						
Direct investment						
foreign investment in Canada[1]	405	660	120	190	145	205
Canadian investment abroad[1]	− 125	10	− 15	− 40	90	− 25
Canadian stocks						
net transactions	− 242	− 83	31	− 39	− 33	− 42
Canadian bonds						
new issues	1,179	1,396	539	355	289	213
special repurchases of Govt. securities	–	−157	− 42	− 80	− 35	–
other retirements	− 374	−343	− 70	− 72	− 53	−148
net trade in outstandings	62	− 99	− 11	− 24	− 50	− 14
Foreign securities						
Government purchases of IBRD bonds	–	− 25	–	–	− 25	–
other transactions	− 84	−332	− 70	− 90	− 89	− 83
Columbia River Treaty						
net transactions	32	32	–	–	–	32
Foreign currency position of Canadian banks vis-a-vis non-residents: net increase (−)	426	−467	−124	12	−271	− 84
Canadian dollar deposits and treasury bills	45	1	− 29	− 9	27	12
Canadian commercial and other paper	10	− 2	− 12	− 5	10	5
Canadian finance company paper	− 162	− 9	23	− 5	− 55	28
Canadian finance companies' other short-term obligations	209	153	34	− 12	44	87
Other long and short-term capital	− 141	−111	−107	32	−195	159
Total capital account transactions	1,240	624	267	213	−201	345
Changes in reserves and IMF position						
Official holdings of gold and foreign exchange	− 11	−462	−166	−181	−105	− 10
Net position with IMF	168	103	28	64	20	− 9
Total	157	−359	−138	−117	− 85	− 19

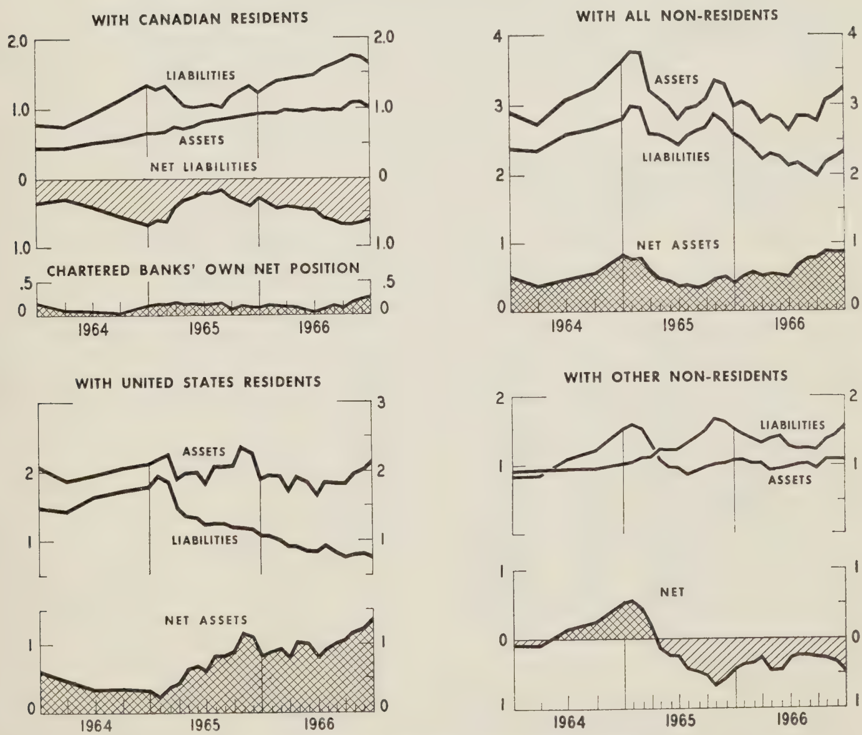
(1) Exclusive of undistributed earnings.

Note: A positive figure indicates an inflow of capital into Canada, and thus an increase in Canadian liabilities or a decrease in Canadian assets. A negative figure indicates the reverse.

There was a sharp swing in the main types of short-term capital flows from a substantial inflow in 1965 to a large outflow in 1966. One of the principal channels was the chartered banks which offer facilities to resident and non-resident clients to hold foreign currency deposits with them against which the banks hold claims on residents and non-residents denominated in foreign currencies. Transactions of this type with residents together with changes in the chartered banks' own foreign currency positions resulted in an outflow of $467 million in 1966 in contrast to an inflow of $426 million in 1965. In 1965 United States residents had withdrawn funds from the Canadian banks in response to the United States balance of payments guidelines, but the chartered banks had met only part of this drain by liquidating investments in the United States. There had been a net inflow of about $950 million from overseas countries with more than $500 million being channelled to the United States and the remainder to Canada. In 1966 there was a further net flow of over

CHARTERED BANKS FOREIGN CURRENCY ASSETS AND LIABILITIES[1]

Billions of Canadian Dollars



1. Assets and liabilities carried on the books of head offices and branches in Canada.

$500 million to the United States with most of the funds coming from a build-up in Canadian resident holdings of foreign currency deposits with Canadian banks, which rose by $400 million, and from an increase in the chartered banks' own foreign currency positions of $150 million. United States residents continued to withdraw U.S. dollar deposits from Canadian banks but at a much less rapid rate than in 1965, and after mid-year the Canadian banks increased their investments in the United States. There was a further small net withdrawal of funds from overseas countries. These developments are summarized in the table below.

CANADIAN CHARTERED BANKS
HEAD OFFICES AND BRANCHES IN CANADA

NET CHANGES IN FOREIGN CURRENCY POSITION(1)

(millions of Canadian dollars)

	1965	1966	1966 1 Q	1966 2 Q	1966 3 Q	1966 4 Q
With non-residents						
United States residents						
Assets	−207	208	−183	− 69	165	295
Liabilities	−727	−309	−156	− 71	− 78	− 4
Net	520	517	− 27	2	243	299
Other non-residents						
Assets	−441	− 2	− 54	− 42	− 42	136
Liabilities	505	48	−205	− 28	− 70	351
Net	−946	− 50	151	− 14	28	−215
Total						
Assets	−648	206	−237	−111	123	431
Liabilities	−222	−261	−361	− 99	−148	347
Net claims on non-residents	−426	467	124	− 12	271	84
With Canadian residents						
Assets	276	84	66	5	− 11	24
Liabilities	−107	401	180	63	208	− 50
Net	383	−317	−114	− 58	−219	74
Changes in chartered banks' own net position	− 43	150	10	− 70	52	158

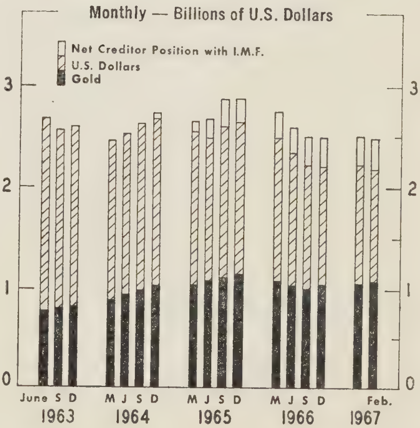
(1) Adjusted for variations in exchange rates.

Non-residents continued to reduce their holdings of Canadian finance company paper in 1966 but at a much less rapid rate than in 1965. In both years there were substantial increases in other short-term investments in finance companies, though the inflow in 1966 was somewhat smaller than in 1965.

As part of the agreement providing for the exemption of the sale of new issues of Canadian securities in the United States market from the Interest Equalization Tax and from the guideline limiting purchases by United States financial institutions of new long-term foreign securities, Canada works to a target level in its foreign exchange reserves, including for this purpose its net creditor position with the International Monetary Fund. In December 1965 Canada agreed, as a contribution to the reduction in the over-all payments deficit sought by the United States Government, to reduce its target figure for reserves from the U.S. $2,700 million figure fixed in 1963 to U.S. $2,600 million, and to aim at achieving the new level by the end of 1966. When in May 1966 Canada paid U.S. $47.5 million in gold to the IMF in connection with an increase of U.S. $190 million in Canada's quota in the Fund it was understood that the gold payment should not alter Canada's contribution to the United States payments position; in effect this amounted to a reduction of the target level for reserves to U.S. $2,550 million.

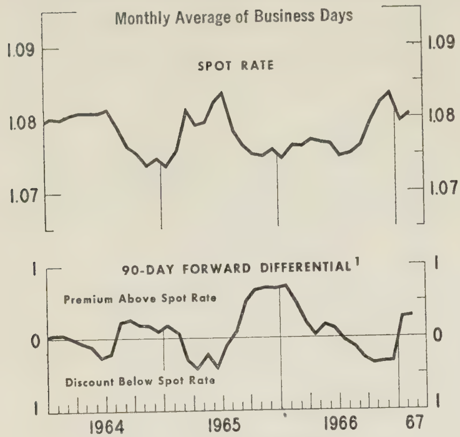
As steps toward the achievement of the end-1966 target level of Canada's reserves the Government repatriated U.S. $145 million of its own U.S.-pay securities and purchased U.S. $23 million of bonds of the International Bank for Reconstruction and Development from United States residents in the course of the first nine months of 1966. Over the year, Canada's reserves declined from U.S. $2,880 million to U.S. $2,499 million; official holdings of gold and U.S. dollars declined by U.S. $429 million while our net creditor position with the IMF increased by U.S. $48 million.

OFFICIAL HOLDINGS OF GOLD AND U.S. DOLLARS AND NET CREDITOR POSITION WITH THE IMF



The spot rate for the United States dollar in the Canadian foreign exchange market fluctuated within a narrow range between 107 11/32 and 107 7/8 during

U.S. DOLLAR IN CANADIAN FUNDS



1. Expressed as a per cent per annum.

the first nine months of 1966. It rose gradually in the final quarter and closed the year at 108⅜. The forward exchange rate for the U.S. dollar in Canada was at a premium until late June when the rate moved to a discount. From mid-September to December the 90-day forward rate for the U.S. dollar remained at a discount yielding about ¼ to ⅝ per cent when expressed at annual rates. In early 1967 the spot rate declined again and the forward rate returned to a premium.

Appendices ▶

APPENDIX TABLE I

BANK OF CANADA NET TRANSACTIONS IN GOVERNMENT OF CANADA SECURITIES IN 1966

(delivered basis – par value in millions of dollars)

	Net purchases from (+) or net sales to (−) investment dealers and banks						
		Bonds[1]					
	Treasury bills	2 and under	2 to 5	5 to 10	Over 10	Sub-total bills and bonds	Securities under PRA
Jan.	+ 4	+ 9	−12	–	–	–	–
Feb.	−33	− 2	+ 4	− 5	− 4	−40	–
Mar.	+84	+ 2	–	–	+ 2	+88	+20
Apr.	+ 3	–	–	–	−13	− 9	−20
May	− 5	+ 12	−16	–	−12	−21	+ 5
June	−20	+ 4	− 4	+ 7	+ 5	− 8	− 5
July	+ 8	+ 2	− 2	–	–	+ 8	–
Aug.	+ 4	+ 34	–	+ 9	+26	+72	–
Sept.	−13	− 4	−11	–	−26	−54	–
Oct.	+35	+ 51	−26	–	−51	+ 9	–
Nov.	–	+ 15	–	–	–	+15	–
Dec.	–	+ 14	–	–	+ 6	+20	–
Total	+68	+137	−69	+11	−66	+80	–

(1) Classified by years to maturity at time of transaction.

Net transactions with Government and other client accounts								
Purchases (+) of new issues less matured holdings		Net purchases from (+) or net sales to (−)				Net change in holdings of Government of Canada securities		
		Securities Investment Acct.		Other Government and client accounts				
bills	bonds	bills	bonds	bills	bonds	bills	bonds	total
−85	− 6	-	− 1	− 18	+ 2	− 99	− 10	−108
−17	+ 4	-	−60	− 15	− 2	− 65	− 65	−130
−17	-	-	+60	− 17	− 2	+ 68	+ 65	+132
+19	-	-	-	− 20	− 1	− 15	− 16	− 31
+41	− 3	-	-	− 25	-	+ 14	− 18	− 4
− 9	-	-	-	− 16	− 5	− 48	+ 6	− 42
+32	-	-	-	− 9	+ 1	+ 31	+ 1	+ 32
+20	-	-	-	− 19	-	+ 5	+ 68	+ 73
−89	+140	-	−10	− 26	-	−128	+ 88	− 39
− 8	-	-	-	− 11	− 2	+ 16	− 28	− 12
+43	-	-	-	− 37	+18	+ 6	+ 33	+ 39
+35	+ 53	-	-	− 21	+ 5	+ 14	+ 78	+ 92
−36	+187	-	−12	−233	+13	−201	+201	+ 1

APPENDIX TABLE II

BANK OF CANADA ASSETS AND LIABILITIES

(monthly changes – millions of dollars)

	Government of Canada securities at book value	Net foreign currency assets	Investment in IDB	All other assets, net	Note circulation	Canadian dollar deposit liabilities		
						Government of Canada	Other	Chartered banks
1966								
Jan......	−108	–	+ 1	−44	−132	−44	+ 6	+20
Feb......	−129	–	+ 2	− 1	− 7	−55	−11	−55
Mar......	+132	–	+ 5	−50	+ 28	+25	+ 2	+32
Apr......	− 30	–	+ 8	+54	+ 33	−14	− 1	+14
May.....	− 3	+ 49	+ 3	−19	+ 33	− 8	+ 5	− 2
June.....	− 43	+ 22	+ 3	+41	+ 35	−11	− 3	+ 1
July.....	+ 31	+135	+ 3	−35	+ 57	+71	− 3	+ 9
Aug......	+ 69	−114	+ 3	+19	− 1	−66	+20	+26
Sept.....	− 38	− 2	+ 2	+18	− 18	+48	−18	−32
Oct......	− 10	+114	+ 7	+ 3	+ 26	+29	+10	+47
Nov......	+ 41	− 24	+ 3	−39	+ 30	−28	− 9	−13
Dec......	+ 91	–	+ 2	+18	+114	−30	− 2	+29
Year...	+ 3	+178	+42	−35	+198	−82	− 5	+77

GOVERNMENT OF CANADA FINANCIAL ACCOUNTS

(millions of dollars)

	Calendar 1964	Calendar 1965	Calendar 1966
Budgetary balance	−153	+ 70	−428
Adjustments from budgetary to National Accounts basis: (plus sign indicates items added to budgetary revenue or deducted from expenditure, minus sign the reverse)			
Government employer-employee pension fund contributions (excluding CPP) and interest earnings, less pension payments	+310	+339	+355
Unemployment insurance and old age security fund receipts, less disbursements	− 37	+243	+277
All other adjustments (net)	+176	− 84	− 64
National Accounts balance	+296	+568	+140
Canada Pension Plan contributions	–	–	+528
Refundable tax on corporate cash profits	–	–	+134
Total	+296	+568	+802
Changes in Financial Assets and Liabilities Sources of funds (−), Uses of funds (+)			
1. Increase in major loans and advances(1)	+368	+642	+1,060
2. CPP Investment Fund acquisition of provincial securities	–	–	+462
3. Increase (+) or decrease (−) in Exchange Fund Account holdings of gold and foreign exchange, other than accruals of earnings	− 13	+ 19	−696(2)
Increase in Canada's subscription to the IMF	–	–	+205
Increase (−) or decrease (+) in notes payable to international organizations(3)	+266	+119	−106
Decrease (+) in Government of Canada U.S. dollar securities outside Government accounts	+ 7	+ 5	+163
Purchases of IBRD bonds	–	–	+ 25
Investment of Columbia River funds in U.S. dollar securities	+220	− 32	− 32
Sub-total of items included under heading 3	+480	+111	−441
4. Increase (−) in Government of Canada Canadian dollar securities(4) outside Government accounts	−210	−166	−301
5. Increase (+) in Canadian dollar cash balances(4)	−196	+147	+ 50(2) (5)
6. Net change in other assets and liabilities	−146	−166	− 28
Total, as above	+296	+568	+802

(1) For details see table on page 52.
(2) Exchange Fund Account holdings of foreign exchange are reduced by (and Canadian dollar cash balances are increased by) $157 million arising from the purchase of foreign exchange from the Exchange Fund Account by the Bank of Canada on a swap basis in connection with its management of chartered bank cash reserves.
(3) Non-interest bearing Canadian dollar demand notes held by the International Monetary Fund and the International Development Association.
(4) As on Bank of Canada books. Accounting differences between these and the Public Accounts are reflected in the item "net change in other assets and liabilities".
(5) Canadian dollar cash balances include $134 million of refundable tax on corporate cash profits.
Source: "Canada Gazette", "Monthly Statement of the Government's Financial Operations". Adjustments to National Accounts basis for 1966 are Bank of Canada estimates.

BANK OF CANADA STATEMENT OF INCOME AND EXPENSES

(thousands of dollars)

	1966	1965
Income		
On investments	$163,894	$154,806
All other income	596	721
Total income	$164,490	$155,527
Operating Expenses		
Salaries(1)	$ 4,889	$ 4,435
Contributions to pension and insurance funds	549	383
Other staff expenses(2)	266	218
Directors' fees	20	22
Auditors' fees and expenses	83	74
Taxes (inc. municipal and business)	1,116	1,036
RCMP guards and electric protection	153	133
Insurance	51	58
Bank notes — production and shipment	4,273	3,893
Premises and equipment (net)	483	510
Stationery and printing	213	185
Publications(3)	100	64
Postage and express	235	202
Telephones and telegrams	180	168
Travel and transfer expense	150	175
Interest paid on unclaimed balances	57	51
All other expenses	188	146
Total operating expenses	$ 13,006	$ 11,753
Depreciation on Buildings and Equipment	899	668
Net Income Paid to Receiver General of Canada	150,585	143,106
	$164,490	$155,527

(1) The number of staff averaged 963 in 1966 and 912 in 1965.
(2) Includes overtime pay, medical services and cafeteria expense.
(3) Printing of "Statistical Summary" and "Annual Report".

ASSETS

	1966	1965
Foreign exchange		
Pounds sterling and U.S.A. dollars	$ 54,906,483	$ 28,021,133
Other currencies	243,844	242,669
	55,150,327	28,263,802
Cheques on other banks	153,208,125	158,100,628
Accrued interest on investments	43,222,855	40,135,130
Investments — at amortized values		
Treasury bills of Canada	409,110,486	608,101,218
Other securities issued or guaranteed by Canada maturing within two years	737,780,442	477,714,658
Other securities issued or guaranteed by Canada not maturing within two years	2,272,400,838	2,330,806,758
Debentures issued by Industrial Development Bank — Note	239,776,843	200,677,869
Other securities — U.S.A. Government	171,738,732	13,989,362
	3,830,807,341	3,631,289,865
Industrial Development Bank		
Total issued share capital at cost — Note	42,000,000	39,000,000
Bank premises		
Land, buildings and equipment Cost less accumulated depreciation	16,541,828	16,296,634
Net balance of Government of Canada collections and payments in process of settlement	64,663,751	41,532,683
Other assets	1,201,760	1,148,857
	$4,206,795,987	$3,955,767,599

Note: The audited financial statements of the Industrial Development Bank as at September 30, 1966 were issued to the public on December 9, 1966.

L. RASMINSKY, Governor
Ottawa, January 26, 1967

A. J. NORTON, Chief Accountant

ASSETS AND LIABILITIES

AS AT DECEMBER 31, 1966
(with comparative figures as at December 31, 1965)

LIABILITIES

	1966	1965
Capital paid up	$ 5,000,000	$ 5,000,000
Rest fund	25,000,000	25,000,000
Notes in circulation	2,733,633,656	2,535,650,110
Deposits		
Government of Canada	34,060,265	116,230,181
Chartered banks	1,111,257,971	1,034,239,537
Other	29,727,708	34,539,477
	1,175,045,944	1,185,009,195
Liabilities payable in pounds sterling and U.S.A. dollars		
To Government of Canada	31,464,061	24,027,229
To others	5,460,415	6,739,614
	36,924,476	30,766,843
Bank of Canada cheques outstanding	229,491,229	172,387,782
Other liabilities	1,700,682	1,953,669
	$4,206,795,987	$3,955,767,599

Auditors' Report • We have examined the statement of assets and liabilities of the Bank of Canada as at December 31, 1966. Our examination included a general review of the accounting procedures and such tests of accounting records and other supporting evidence as we considered necessary in the circumstances. In our opinion, the accompanying statement of assets and liabilities presents fairly the financial position of the Bank as at December 31, 1966.

T. A. M. HUTCHISON, F.C.A.
of Peat, Marwick, Mitchell & Co.

H. MARCEL CARON, C.A.
of Clarkson, Gordon & Cie.

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•

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R. W. Lawson, *Deputy Governor*
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A. J. Norton, *Chief Accountant*

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W. A. McKay, *Assistant Chief*
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D. B. Bain, *Administrative Assistant*
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I. A. Stewart, *Research Officer*
L. E. Barclay, *Industrial Research Assistant*
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D. G. M. Bennett, *Securities Officer*
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J. E. J. Clément, *Securities Officer*
D. M. Cockfield, *Securities Officer*
F. Faure, *Securities Officer*
R. C. Page, *Securities Officer*
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T. G. Boland, *Montreal Representative*
A. W. Noble, *Associate Toronto Representative*

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P. Watt, *Deputy Chief*
A. C. Lord, *Assistant Chief*

* On leave of absence as an Executive Director of the International Monetary Fund.

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BANK OF CANADA

ANNUAL REPORT OF
THE GOVERNOR TO THE
MINISTER OF FINANCE

AND STATEMENT OF ACCOUNTS

FOR THE YEAR 1967

BANK OF CANADA *Ottawa 4*

February 29th, 1968.

The Hon. Mitchell Sharp, P. C.,
Minister of Finance,
Ottawa, Ontario.

Dear Sir,

In accordance with the provisions of the Bank of Canada Act I am transmitting herewith my report for the year 1967 and a statement of the Bank's accounts for this period which is signed and certified in the manner prescribed in the by-laws of the Bank.

Yours very truly,

Governor

BANK OF CANADA

Report of the Governor — 1967

Some Highlights of the Year

In the period since the publication of my last Report, Canada's economic and financial situation has been characterized by a number of cross-currents which have confronted the central bank with some unusually difficult problems.

Domestically, the slackening pace of economic expansion, which would normally call for policies to stimulate demand, has gone hand in hand with a continued upward push of costs and prices. The levelling out of private investment, which would ordinarily be expected to ease upward pressures on interest rates, has been accompanied by extremely high interest rates—and for most of 1967 these rates would have been higher still if the central bank had not permitted an unusually large expansion of the banking system to take place in order to accommodate part of the special demands for credit and liquidity that were pushing interest rates up.

Outside the country, the world currency situation became strained towards the end of the year when sterling was devalued. Subsequently there were substantial losses of gold by the United States and the countries of the gold pool. At the beginning of 1968 the United States announced a fresh balance of payments programme designed to improve its payments position by $3,000 million in the course of the year. Against the background of unease in international financial markets, this programme triggered off some abnormal selling of Canadian dollars in the exchange market in the second half of January. The Bank of Canada raised its Bank Rate—which had already been increased from 5 to 6 per cent at the time of the devaluation of sterling—to 7 per cent on January 22, and market rates of interest have risen substantially.

These unusual developments—and the structural changes in the financial system resulting from the revision of the Bank Act, to which I refer later—have been the main pre-occupations of the central bank in the past year. The policies followed reflect the relative importance attached to the frequently conflicting considerations we have had to weigh. The main developments in the international economic environment and in domestic financial and economic conditions are described in the later sections of this Report, as are the monetary operations of the Bank. I wish here to make some general comments on what seem to me to be the highlights of the year.

*　　*　　*

I start with the economic situation. Since the middle of 1966 the economy has been going through a period of adjustment following the very rapid expansion that began in 1961. Real output (excluding variations in farm crops) has been increasing at a rate of about 3 per cent per annum during this period of adjustment. This is about half the rate of the preceding 5 years and it is well below our potential for growth. But once the effective slack in the economy had been taken up, the 6 per cent growth rate was clearly unsustainable and it became obvious that the excessive pressure of demand on our resources was giving rise to serious strains in the economy. There is reason for some satisfaction that the adjustment from the unsustainable rate of expansion has taken place without causing a down-turn. The economy has continued to expand, though at a more moderate rate.

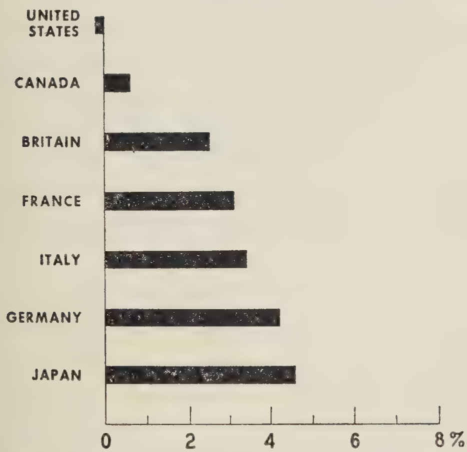
It is, however, disappointing that the reduced pressure of demand and the emergence of some slack in the economy is not yet reflected in a more satisfactory performance of costs and prices. The broadest statistical measure of prices, the GNP price deflator, continued to rise in 1967 at close to the same rate as in 1966, about 4½ per cent, while the Consumer Price Index also continued to go up rapidly. It is true, of course, that in any period of very strong demand such as we experienced in late 1965 and early 1966, some increases in costs get built into the system and that it takes time for them to work their way through. There is therefore bound to be a lapse of time before the moderation in the pressure of demand in the economy is reflected in a slowing of price increases. As this is written, there are a few hopeful—but as yet inconclusive—signs that this may at last be beginning to happen. No doubt the fact that the economic adjustment has been modest, and that output and employment levels have on the whole been well sustained, has delayed the price and cost response. Nevertheless it has to be recorded that the recent behaviour of costs, and in particular the very high rates of increase in wages and salaries, has been a major factor in the failure to achieve a better price performance. The delay in returning to reasonable stability in prices and costs inevitably impedes a return to a more vigorous rate of expansion of the economy on a non-inflationary basis.

In thinking of our recent cost and price performance it is important to maintain a sense of perspective. It is true that the recent performance has been distinctly unsatisfactory. Our productivity gains have been inadequate. We have been paying ourselves increases in incomes which have gone well beyond the amounts that we have really earned through increased output, and consequently prices—despite some erosion of profit margins—were bound to rise. This is a self-destructive process, and in my judgment public and private policies should be directed to ensuring that the process is brought to an end. At the same time, we should not lose sight of the fact that over the period of the economic expansion as a whole our cost and price performance compares

favourably with that of most other industrial countries. This is illustrated in the two graphs below. One of these, which is based on the February 1968 Report of the Council of Economic Advisers of the United States, compares the average annual percentage change between 1961 and 1966 in labour costs per unit of output in manufacturing in seven principal industrial countries. It shows that over this period as a whole the United States was the only country whose record was better than that of Canada. The second graph, which compares the quarterly movements of labour costs per unit of manufacturing output in Canada and the United States since 1963, suggests that since the beginning of 1966 unit labour costs in manufacturing in the United States have risen almost as rapidly as in Canada.

LABOUR COSTS PER UNIT OF OUTPUT IN MANUFACTURING

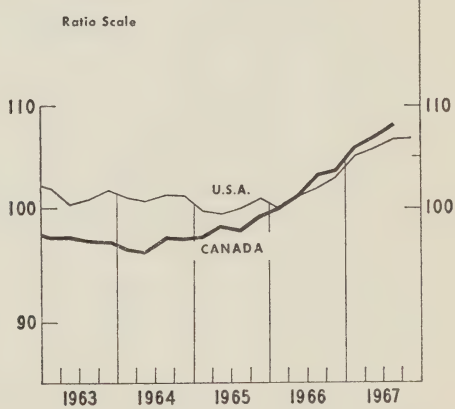
Average Annual Percentage Change
1961–1966



Source: The Annual Report of the U.S. Council of Economic Advisers, February 1968.

LABOUR COSTS PER UNIT OF OUTPUT IN MANUFACTURING CANADA - U.S.A.

Quarterly — Index 1Q 1966 = 100



Seasonally adjusted.

I hope it will not be thought that in providing this perspective I am now taking a sanguine view of recent cost increases in Canada. Far from it. The upward slope of the Canadian cost curve is disturbing for many reasons; and even though the recent slope of the American curve is almost the same as ours, it is not good enough, having regard to our international position and particularly the large volume of our trade and other transactions with the United States, for us to do as well (or as badly) as the United States: we must seek to do better. I therefore continue to regard it as a matter of the greatest importance for Canada to taper off the increase in costs and prices and bring it to an end. I continue to hope that exclusive reliance will not be placed on monetary and

fiscal policy to achieve this result, since without the support of other types of policy action its achievement might well require acceptance of an unnecessary amount of under-employment of productive resources. I hope that the public authorities will take the lead in seeking to influence the various groups in the economy who wield market power to relate their demands for increases in money incomes more realistically to increases in their real output than has been the case during the past couple of years.

* * *

I turn now to monetary policy and the financial system. As is always the case, monetary policy in 1967 had to take account of external as well as domestic considerations. Some of the domestic considerations closely paralleled similar considerations in the United States, but some were particular to Canada. In the closing months of 1967 and the first months of 1968 external considerations played a decisive role in the policies followed by the Bank.

As 1967 opened, interest rates were trending down and they continued to do so for the first few months of the year. Credit conditions had become very tight in 1966, and with the evidence of a slackening in the pace of economic activity I welcomed the opportunity to help bring about some easing of credit conditions, which was also appropriate to our international position. The Bank Rate was reduced from 5¼ to 5 per cent on January 30 and, in the light of the continued reduction in market rates of interest which occurred in the interval, it was again reduced, to 4½ per cent, on April 7.

The cross-currents in financial markets which led to the unusual combination of rising interest rates and abnormally high rates of monetary expansion in both Canada and the United States came to the surface early in the spring. There were a number of distinct but inter-related factors at work. One was the emergence of fairly widespread expectations that the economic adjustment through which North America was passing would be of short duration, and that the slower pace of current economic activity would give way to strong expansion later in the year, particularly in the United States. If this occurred, it would involve increased demands for credit to finance the expansion; and businessmen—no doubt recalling the great reliance that had been placed on monetary policy in 1966 to moderate demand pressures—were inclined to rebuild the liquidity they expected to need in the future by borrowing immediately. This strong desire for liquidity, also shared by some financial institutions which had permitted their own liquidity to run down in 1966, naturally put upward pressure on interest rates. Another factor operating in the same direction was some expectation, which seems to have influenced investors and borrowers alike, that prices in North America would continue to rise. A further element in the situation was the greatly increased demand for funds on

the part of governments. As indicated in a later section of this Report, the Government of Canada's financing requirements increased from about $100 million in 1966 to $1,200 million in 1967 while provincial and municipal requirements (apart from the large and increasing amounts covered by the Canada and Quebec Pension Plans) rose from $1,600 million in 1966 to about $1,900 million in 1967.

The basic problem for monetary policy in 1967 was to decide how far to permit the very large demands for funds in capital and credit markets resulting from all these factors, including increased liquidity preference and increased Government cash requirements, to exert upward pressure on interest rates and how far to accommodate the demand by permitting increased monetary expansion. In the event, we experienced a mixture of the two—rising interest rates and considerable monetary expansion—until the closing months of the year when there was a marked slowing down in the rate of monetary growth.

There was a distinct improvement in one of the elements of the situation at the end of November when the Government of Canada announced that as a contribution towards financial stability it intended to reduce its cash requirements by more than 50 per cent during the next fiscal year. The measures proposed provided for a slowing down in the growth of expenditures (both budgetary and non-budgetary) and an increase in revenues.

The central bank's problem in deciding how much monetary expansion to permit in order to restrain the rise in interest rates was complicated by the structural changes which were occurring in the banking system as a result of the Bank Act revision which went into effect in May 1967. The general effect of this revision was to make the financial system more competitive by softening or removing most of the special restrictions under which the banks had been working. The banks naturally took advantage of these changes to compete more aggressively for an enlarged share of the total financial business of the community. Indeed, for a period in the autumn their competition for large blocks of short-term corporate funds was so aggressive that it appeared to be uneconomic, and I felt that it threatened to introduce some instability and distortions into the financial system. I informed the banks of my views and was gratified that a more normal relationship of rates came about soon thereafter.

The structural changes in the financial system meant that part of the apparent monetary expansion represented the capture by the banks of a larger share of the growth in deposits. Some part of the large increase of 14 per cent in total holdings of currency and bank deposits in 1967 (16 per cent if Government deposits are excluded) was due to these structural changes, and consequently the increase in the liquidity of the public which these figures suggest is exaggerated. It makes no difference to the spending behaviour of the holder

whether a given type of liquid claim is held with a chartered bank (and hence forms part of the money supply as traditionally defined in Canada) or with some other financial institution (and does not). On the basis of the definition of money supply commonly used in the United States, which includes, along with currency, only demand deposits at commercial banks and not savings or time deposits, the increase in Canada in 1967 was 8 per cent (about the same as in 1966) as compared with 6½ per cent in the United States.

When all is said and done, however, it remains the case that the central bank allowed a relatively rapid rate of monetary expansion to occur until the closing months of 1967. The alternative was to permit the market pressures to exert an even stronger and earlier impact on interest rates. Having regard to both domestic considerations and the need at the time to avoid excessive capital inflows, it was my judgment that this would not have been desirable.

* * *

Since November, the situation in Canada, and indeed throughout the world, has been affected by the devaluation of sterling and its consequences. The over-all reaction to the devaluation of sterling was orderly and restrained; only a few countries followed Britain with devaluations of their own currencies. However, there was some weakening of confidence in the stability of the world structure of exchange rates which set off some speculative activity against other currencies and large-scale buying of gold. The United States made clear its firm intention of maintaining the $35 price per ounce of gold and, with substantial help from the gold pool countries, met the private demand for gold. Canada sold the United States $100 million of gold in December and at the same time, as a further measure of international co-operation, the Bank of Canada requested Canadian banks and other financial intermediaries to refrain from extending credit on gold or on other security for the purchase of gold. The Bank also requested Canadian financial intermediaries not to facilitate forward purchases of gold.

The publication on January 1, 1968 of the new United States balance of payments programme, which is described in detail in the next section of this Report, was followed later that month by pressure on the Canadian dollar in the exchange market. This was reflected in a loss in January of about $350 million in reserves, of which $250 million was offset by the Bank of Canada drawing on its $750 million swap line with the Federal Reserve System. On January 21 a statement was issued by the United States Treasury making it clear that the new United States programme was not intended to produce abnormal transfers

of funds from Canada to the United States by Canadian subsidiaries of American companies and that the programme left room for large flows of capital to Canada. For its part, the Bank of Canada requested the banks, and the banks agreed, to discourage the use of bank credit by subsidiaries to facilitate abnormal transfers of funds abroad or to replace funds normally obtained in the past from parent companies. The Bank Rate was increased to 7 per cent, and since that time monetary policy has been primarily directed to stabilizing the situation in the exchange market. This has involved a considerable increase in the level of market interest rates and a widening of the spread between rates in Canada and the United States which should encourage new borrowing by Canadians in the United States and the repatriation of short-term assets held abroad.

There was some additional decline in reserves in February and towards the end of the month the Government strengthened the official reserves of gold and United States dollars by drawing $426 million from the International Monetary Fund; this represents the amount of credit that Canada has in the past extended to other countries through the Fund plus an amount equivalent to Canada's gold subscription to the Fund.

It may be worth recalling—as a reminder of the speed with which opinions in these matters can change—that it is only a few months since there was a good deal of concern about our balance of payments position being too strong because our exchange reserves had temporarily risen above the target level in the reserve agreement with the United States. For my part, I have long felt that our over-all economic position would be better if we were not so dependent on capital imports, particularly when the country from which we must import most of the capital has a payments problem itself. We appear to have been making some progress in reducing our current account deficit. Last year there was an extraordinarily large reduction—from $1,140 million in 1966 to $425 million. While the improvement in 1967 was in considerable degree due to a special temporary factor (the unusually high level of tourist receipts associated with Expo), a longer-term perspective also suggests that the underlying position has improved. If one regards the 1965-66 level as giving a better indication of the underlying position, our current account deficit is now equivalent to about 2 per cent of our GNP compared to about 4½ per cent in the mid-fifties, the last time we had as high a level of resource use in the economy.

It is true that our current account deficit is still large and that it must be covered by capital inflows. While there has recently been a small but welcome development of Canadian borrowing in Europe we must primarily look to the United States for the capital required to offset our current account deficit. The

United States has a large over-all payments surplus with Canada, and it is to be noted that the special trade and payments relationships between the two countries have been taken into account to a considerable extent in framing the detailed balance of payments measures which have been announced by the United States. It is not possible to calculate the impact of these measures on United States direct investment in Canada, partly because Canada is grouped with a number of other countries, but scope for a continued substantial inflow of this sort of capital remains. Canada continues to have unrestricted access to the new issue market, with a complete exemption from the guidelines on longer-term foreign investment by financial institutions and from the Interest Equalization Tax. Canada may actually stand to gain from the proposed United States restrictions on foreign travel which are aimed at countries outside the Western Hemisphere.

Canada is not uncompetitive in world markets. On the contrary, our merchandise trade surplus has been rising. Where there is legitimate cause for concern is in the prospective trend of costs and prices if we do not strive for better performance. As I have pointed out, the cost increases are of fairly recent origin, and costs elsewhere have also gone up; it is by no means impossible for us to protect our competitive position, and even improve it, particularly in a world where other countries are confronted with similar problems of inflation. But we should not rely on the difficulties of others to help us. We have to maintain the strong underlying position of the Canadian economy through our own efforts.

* * *

The devaluation of sterling and the balance of payments programme of the United States involve substantial problems of adjustment for the rest of the world. All countries have a great interest in the strength and stability of the United States dollar and must therefore welcome the determination of the United States Government to reduce the deficit in its balance of international payments. By and large, the counterpart of the reduction which is required in the United States and the British deficits must be a reduction in the international surplus positions of those countries that do in fact have balance of payments surpluses and strong reserves. In the main these are the countries of the European Economic Community. The United States sought to recognize this in the formulation of its programme. The Common Market countries appear, for their part, to have accepted the view that it is their responsibility in present

circumstances to facilitate a major reduction in their external surpluses and to follow internal policies that are sufficiently expansionary.

A risk that must be avoided in the widespread adjustment of international payments positions is that of throwing countries with weaker balances of payments positions into unmanageable deficits; if this happens the necessary efforts of these countries to protect themselves would only add to the general problem.

It cannot be taken for granted that an adjustment in world trade and capital flows of the magnitude now being attempted by the two reserve currency countries can be brought about without difficulty. The greatest care must be taken by all governments not to act in a way that jeopardizes the gains that all countries have obtained over the past decades from the liberalization of international trade, or to take steps that invite retaliation. The present system of trade and payments has served the world well, and it is in the interests of all that it should be maintained.

As the world moves towards a better balance of payments equilibrium and as the payments deficit of the United States is reduced, the problem of providing for the future world requirements of international liquidity will arise in a practical form. This contingency has been foreseen and preparations for it have been made. After several years of study and negotiation, agreement was reached at the Annual Meeting of the International Monetary Fund in Rio de Janeiro last September on the broad outline of a plan to create through the Fund a new international reserve asset to supplement gold and the reserve currencies, to be known as a Special Drawing Right.

Some of the precise details of the Plan still have to be worked out, but this should not be too difficult now that the major and very important decision has been taken to establish machinery for the deliberate creation of international reserves. In my judgment it is now appropriate to proceed with despatch to put the machinery into place and to activate it. This will inevitably take time, but so long as progress towards the creation of the new reserve asset is well maintained, the world will not need to fear a shortage of international liquidity. If necessary, existing techniques of liquidity creation can be extended, including special use of the International Monetary Fund and a further development of central bank co-operation. More important, so long as progress is being made countries will act with greater confidence in their trade and payments policies. Progress in improving the international monetary machinery must, of course, be paralleled by continued efforts by all countries, both individually and in consultation, to follow domestic policies which encourage the achievement and maintenance of equilibrium in their international payments positions.

* * *

In concluding this section of my Report, I wish to record that the Bank of Canada had the pleasure, in May 1967, of acting as host at the Fourth Annual Meeting of the Governors of the Central Banks of the Western Hemisphere. This meeting took place at Mont Gabriel, Quebec, and brought together the Governors of the central banks of 25 countries, including the countries of Latin America and the Caribbean, as well as the Chairman of the Board of Governors of the Federal Reserve System and the President of the Federal Reserve Bank of New York, and other senior officers of the central banks. The discussions, which extended over several days, were interesting and fruitful and resulted in a further strengthening of the ties of friendship between Canada and the countries of this Hemisphere.

The External Economic Environment

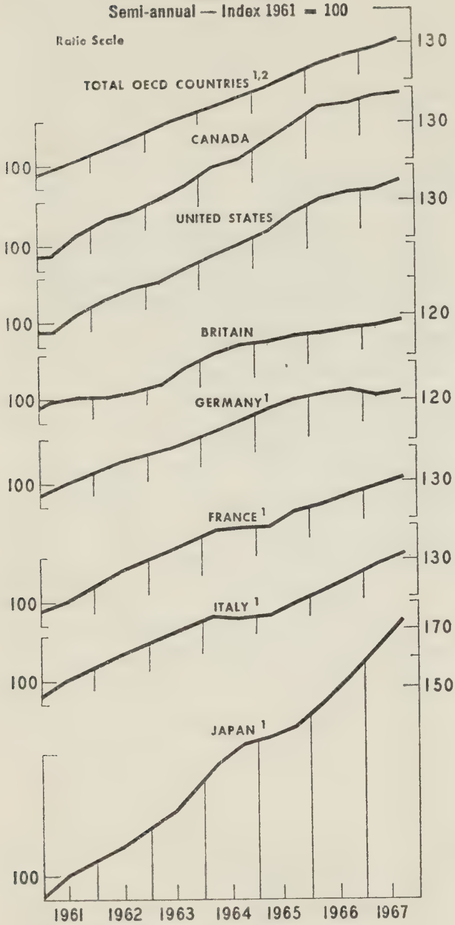
Canada's external economic environment was somewhat less favourable in 1967 than it had been for several years. In the first half of the year world output and trade continued to be adversely affected by the adjustments taking place in the United States, Britain and Germany: the simultaneous slowdown of activity in three such important trading countries inevitably had a significant impact on output elsewhere. The easing in the pressure on resources was accompanied by some improvement in the performance of prices and costs in many European countries. After mid-year the economies of the United States and Germany returned to normal rates of growth and a general quickening in the tempo of activity in the industrial countries took place. However, there was an intensification of the balance of payments problems confronting the two reserve currency countries, which culminated in the devaluation of sterling and related measures in November and the announcement by the United States at the beginning of 1968 of a new programme of more stringent balance of payments measures. The effort by the two reserve currency countries to achieve major improvements in their payments positions will exert an important influence on world trade and payments in 1968.

OUTPUT, EMPLOYMENT AND PRICES. Total output for the OECD countries as a group (as shown in the chart on page 16), which account for the bulk of Canada's trade, is estimated to have risen at an annual rate of 2 per cent in the first half of the year and 4 per cent in the second half of the year. Public expenditures have continued to provide an expansionary stimulus in virtually all of these countries and the fluctuations in output were mainly due to changes in private demand and exports. The easing in private domestic demand in the United States, Britain and particularly in Germany had an adverse effect on the exports of most other industrial countries.

In the United States the increase in Gross National Product in real terms slowed down to an annual rate of about 1½ per cent in the first half of 1967, but accelerated again to a rate of 4 per cent in the second half of the year. For the year as a whole the growth in real GNP was 2½ per cent, which compares with an increase of almost 6 per cent in 1966. In part because of monetary and

GROSS NATIONAL PRODUCT

Constant Prices
Semi-annual — Index 1961 = 100



Seasonally adjusted.
1967 preliminary estimates.
1. Annual plots prior to 1964.
2. Includes countries shown plus Austria, Belgium, Denmark, Greece, Iceland, Ireland, Luxembourg, Netherlands, Norway, Portugal, Spain, Sweden, Switzerland and Turkey.

fiscal measures designed to dampen the expansion of over-all demand, private expenditures, exclusive of inventory change, had moderated in the latter part of 1966. However, this had been accompanied by an extraordinarily large build-up of inventories and the subsequent inventory adjustment was the principal retarding force in the early part of the year; this inventory adjustment was equivalent to more than 2 per cent of GNP between the fourth quarter of 1966 and the second quarter of 1967. There was some acceleration in final demand during this period resulting from the stimulus provided by rising Federal expenditures, particularly military outlays, and an expansionary monetary policy. In the private sector there was a pronounced recovery in residential construction, which had been drastically reduced during the credit squeeze in 1966. In the second half of the year, housing expenditures continued to rise strongly and there was also a pick-up in business fixed investment and a return to fairly high rates of inventory accumulation. Consumer expenditure advanced throughout the year, though less strongly than income; the rate of personal saving was higher than it had been in more than ten years. For 1968 the official United States forecast calls for a faster rate of growth than in 1967; assuming passage of the tax measures referred to later, GNP in real terms is expected to increase by a little more than 4 per cent—about in line with the long-term potential.

Economic developments in the British economy over the past few years have been dominated by the persistent balance of payments disequilibrium and the measures taken to deal with it. Total output remained virtually unchanged

through the first half of 1967 although there have been indications of some increase more recently. In Germany, where measures to contain inflationary pressure had been taken late in 1965 and early in 1966, domestic demand fell sharply from mid-1966 to mid-1967. Monetary policy eased substantially beginning late in 1966 and the German Government introduced two programmes of fiscal stimulus in the course of 1967. By year-end there were clear indications of accelerating economic growth. The growth in real output in most other European countries was somewhat slower in 1967 than in the previous year, reflecting principally the situations in the important German and British markets. In France the rate of economic expansion has tended to fall short of the official target; a margin of unused capacity has emerged, and in January 1968 the French authorities announced measures to stimulate the economy.

Italy remained in a balanced phase of expansion through the year, partly as a result of the success of the earlier stabilization programme and a revival of private investment. This was also broadly true in Japan but towards year-end the growing current account deficit led to the introduction of measures of restraint, including a more restrictive monetary policy.

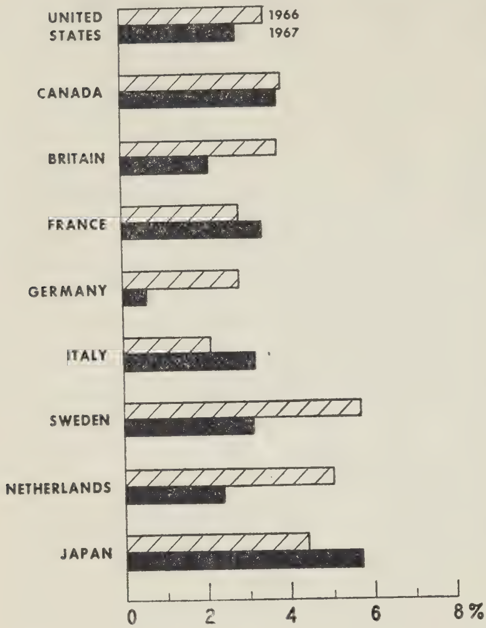
The slowdown in the rate of economic expansion in Western Europe was accompanied by a fairly general easing in labour markets. Indeed, with the exception of Italy, unemployment in Europe reached the highest level in over a decade. However, towards year-end there were indications of a firming in labour demand in Germany and Britain with the recovery of economic activity in these countries. In Japan the labour market remained relatively tight.

In the United States, a decline in employment during the first part of the year and a rebound in the second half just about matched the concurrent changes in the labour force, and—except for a short period in the fall, when the automobile industry was affected by a strike—the seasonally adjusted unemployment rate held relatively steady at, or a little below, the 4 per cent level. In January 1968 the unemployment rate was down to 3½ per cent. The 2½ per cent increase in real output in 1967, taken in conjunction with a 2.4 per cent rise in total employment indicates little, if any, change in output per worker from the previous year.

Despite the decline in the rate of expansion and an increase in the margin of unused manufacturing capacity in the United States in 1967, there was little apparent alleviation in cost and price pressures. Labour contracts covering an unusually large number of workers were negotiated, with settlements providing for average pay and benefit increases that were appreciably larger than in 1966. This, combined with the relatively poor productivity performance, resulted in a further increase in average wage and salary costs per unit of output. The price index of all goods and services, as measured by the GNP price deflator registered a 3.0 per cent advance during the year compared with a 3.2 per cent increase during 1966. On the other hand, the increase in the Consumer Price Index

CONSUMER PRICE INDICES

Percentage Increase : Year Ending Fourth Quarter



was held to 2.8 per cent, as against 3.5 per cent during 1966; food prices increased much less in 1967 than in 1966 but prices of "all other goods and services" rose by 3.4 per cent, slightly more than during the previous year.

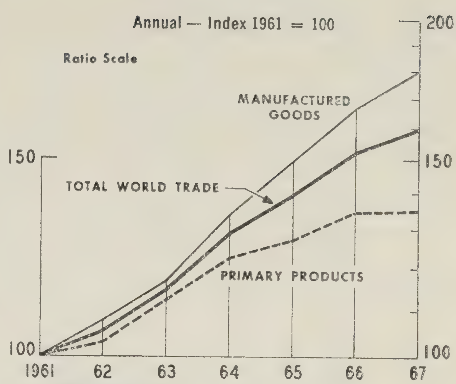
There was some moderation of inflationary pressures in a number of European countries, and the deterioration in European unit labour cost performance relative to that of the United States, which had persisted since 1961, appears to have been arrested. Since the middle of 1966 there has been a marked improvement in the price performance of Germany, the Netherlands and Britain. This reflected the slower pace of economic activity in these countries and in the British case the implementation of a temporary prices and incomes "freeze" and a subsequent period of "severe restraint". The very high rate of economic expansion in Japan was accompanied by price increases which again reached the annual rate of over 5 per cent typical of the early 1960's. Inflationary pressures have not been as serious in France and Italy in recent years, although prices began to increase more rapidly during 1967. Despite some recent moderation, the Scandinavian countries are still experiencing persistent price pressures. In general the behaviour of costs and prices in the industrialized countries over the last two or three years highlights the difficulties they are all experiencing in combining high levels of economic activity with reasonable cost-price stability.

TRADE AND PAYMENTS. World trade remained remarkably buoyant through the first quarter of 1967 but then weakened until late in the year. For the year as a whole the increase was about half the 10 per cent average annual rate attained in the previous four years. The slowdown in world trade was most pronounced in primary products and was influenced by the general easing in demand for industrial raw materials and by the record crops harvested in some of the major food-importing countries. Wheat prices weakened during the year. Late in the year there were some indications that the accelerating

pace of output in the industrial countries was beginning to have an impact on world trade, which should be further stimulated by the implementation of the "Kennedy Round". On the other hand, sterling devaluation and the United States balance of payments programme could exert a restraining influence.

The diverse changes in economic activity and in costs and prices which have been described were reflected in the current account balance of payments positions of the industrialized countries.

WORLD TRADE[1]



1967 preliminary.
1. Total exports f.o.b.

In the United States the slowing in economic activity in the early part of the year was accompanied by a modest contraction in merchandise imports; exports were well maintained and the trade surplus improved. Late in the year, however, as domestic activity quickened, imports rose sharply and there was a marked deterioration in the trade surplus in the final quarter. The trade surplus for the year as a whole was $3.6 billion, about the same as the 1966 figure. At the same time there appears to have been a less favourable balance on services account when military transactions are included, and indications are that the combined surplus on goods and services in 1967 was below the $4.1 billion figure for 1966.

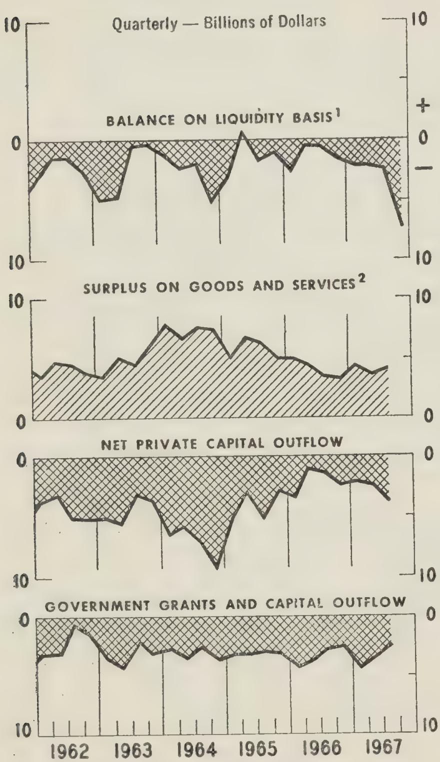
The collective current account surplus of the European Economic Community increased sharply over the past year. In Germany, the easing of domestic demand was reflected in a reduction in imports; as exports continued to rise rapidly the current account as a whole shifted from virtual balance in 1966 to a surplus position of $2½ billion in 1967. Italy's exports expanded quite rapidly again in 1967, despite a pause in sales to Germany, but a greater increase in imports led to a $½ billion reduction in Italy's large current account surplus. France was somewhat more adversely affected by the German situation and moved from a position of near-equilibrium to a modest deficit as its trade imbalance with the non-franc area widened. The Benelux countries were in modest surplus through the year.

In Britain, the current account moved into a surplus in the last quarter of 1966 and the first quarter of 1967, then swung back into deficit. For the year as a whole the current account deficit increased by about $½ billion. Among the factors which contributed to this result were sustained high import demand after the removal of the surcharges, set-backs to exports due to the Middle East

crisis and the dock strike, and intensified competition for British industry in home and foreign markets arising from the growth of excess capacity in Germany and elsewhere in Europe. In Japan the emergence of a trade deficit caused the current account to swing into deficit, which widened through the year.

There was a substantially larger net outflow of capital from the United States in 1967 than in 1966 and preliminary estimates indicate a balance of payments deficit on a liquidity basis of $3.6 billion, compared with $1.4 billion in 1966. Much of the deterioration took place in the fourth quarter. While part of the increase in the over-all deficit in that period reflected a reduced trade surplus, there was also a sizeable capital outflow. One special factor in this was the liquidation of the British Treasury's remaining "dollar portfolio", amounting to some $500 million. Another factor cited by the Administration as contributing to the increase in the "liquidity deficit" in the latter part of the year was the absence, in contrast to the situation in 1966 and the first half of 1967, of a substantial inflow in the form of foreign official acquisitions of long-term time deposits. Direct investment abroad in 1967 appears to have been somewhat smaller than the 1966 figure of $3.5 billion, and Government net capital outflows were apparently little changed for the year as a whole.

UNITED STATES BALANCE OF PAYMENTS



Seasonally adjusted at annual rates.

1. As measured by changes in U.S. official reserve assets and in liquid liabilities to all foreigners.
2. Including net military expenditures abroad.

In Britain, where measures have been taken in recent years to restrict the traditional outflow of long-term funds, this part of the capital account was in rough equilibrium. On the other hand, Germany became a net exporter of private long-term capital for the first time since 1959.

After having remained virtually constant over the past five years, the flow of development capital to the less developed countries increased substantially in 1967 and helped to offset an easing in export earnings. However,

part of this increase resulted from an acceleration of disbursements under existing aid commitments to India, owing to the critical crop situation in that country. Future aid commitments have been curtailed because of the international payments problems of some of the industrialized countries, and the effort to provide additional resources to the International Development Association has proceeded with some difficulty. To a limited extent this problem has been alleviated by the establishment of regional development banks and bond flotations in the Euro-bond market. The continuing problems of the mobilization of development capital and of debt servicing are currently under discussion at the second United Nations Conference on Trade and Development meeting in New Delhi.

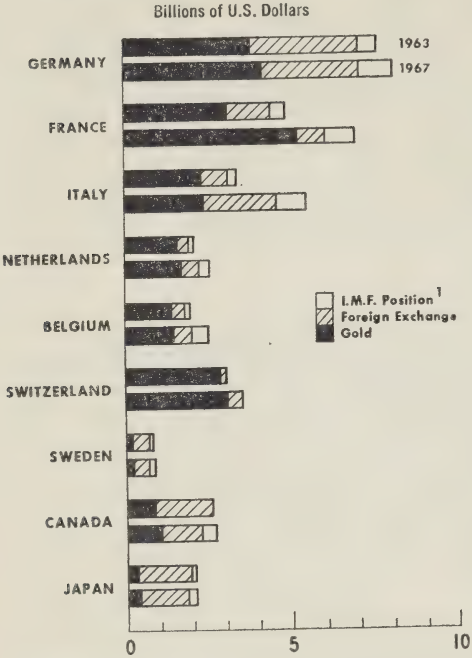
Massive short-term capital flows were again a feature of the international payments system. Some of these movements played an equilibrating role. For the year as a whole, Germany was a large net exporter of short-term funds, while Japan was a major recipient; in both cases these short-term capital movements helped to neutralize the swings on current account. On the other hand, the uncertain position of sterling in the exchange market before the devaluation in November gave rise to large and disturbing short-term flows. To a considerable extent the outflow from Britain was offset by the activation and expansion of central bank facilities.

The net changes in official reserve assets plus International Monetary Fund positions in 1967 were again relatively small despite the unsettled conditions in the exchange markets late in the year. Foreign exchange holdings rose by about \$3½ billion but there was a decline in official gold holdings of \$1½ billion and in IMF positions of \$0.6 billion. The latter reflected repayments to the IMF by Britain.

Although the degree of imbalance in the international payments system increased in 1967 its general character remained the same: Britain and the United States continued to have the main deficits in the system (financed mainly by increases in their liquid liabilities to foreigners and in the case of the United States by a reduction in its gold holdings) while the countries of the European Economic Community accounted for an important part of the corresponding surplus (reflected primarily in increases in their official reserves).

The structure of the British and American deficits is quite different. Instead of its traditional current account surplus, Britain has had a current account deficit averaging nearly \$600 million over the past four years. This contributed to a weakening of confidence in sterling and to short-term capital outflows which greatly increased Britain's total payments deficit. In contrast, the United States continued to have a surplus on current account, which averaged

OFFICIAL HOLDINGS OF RESERVE ASSETS
Selected Non-reserve Currency Countries



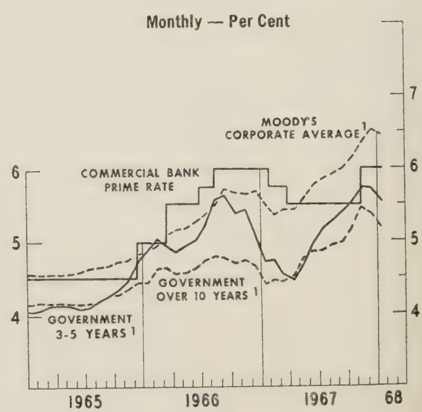
1. The amount by which a country's quota exceeds the I.M.F.'s holdings of its currency plus loans to the I.M.F.

$5,300 million a year during this period. This very large current account surplus was, however, substantially exceeded by total net outflows of private long-term capital, Government military expenditures abroad, and development assistance.

There have been swings in the payment positions of individual EEC countries, but the Community as a whole has maintained a current account surplus which averaged over $2,000 million a year in the last four years. This has been offset only in part by a net outflow of capital, and official holdings of reserve assets by these countries in these years have risen by an average of $1,300 million annually. During this period there has also been a large increase in private holdings of liquid foreign assets by residents of these countries.

FINANCIAL POLICIES. As economic activity in the United States slowed down in 1966 there was a shift to a policy of monetary ease which provided for a rapid expansion in bank credit in 1967. During the course of the year the money supply, as measured by currency and total bank deposits, increased by 11 per cent, over twice the rate of 1966. Although credit became more readily available, pressure on the capital markets remained intense for most of the year and interest rates resumed an upward course after only a relatively brief

UNITED STATES INTEREST RATES



1. Monthly averages of daily figures.

interruption. Towards year-end, long-term rates reached their highest level in 40 years or more; there has been some easing in the more recent period. On the fiscal side, the investment tax credit and accelerated depreciation provisions, which had been suspended in the fall of 1966, were reinstated in the spring of 1967. Expectations of a sharp rise in economic activity later in 1967 and the desire to reduce the large Federal budget deficit led the Administration to ask for a temporary tax surcharge on personal and corporate tax liabilities, effective in mid-1967. Congress withheld approval of the request pending assurances of reduced Federal expenditures and the proposal, which now calls for a 10 per cent surcharge on personal tax liabilities effective April 1, 1968 and a similar increase in corporate tax liabilities retroactive to the beginning of 1968, is still under consideration by Congress. In the meantime, some progress has apparently been made towards limiting the growth in Federal expenditures and monetary policy has become less expansionary; there has been a reduction in member bank free reserves and a considerably slower growth in the money supply since last fall. Following the devaluation of sterling in November, the Federal Reserve discount rate was increased to 4½ per cent from 4 per cent and in December the Federal Reserve Board announced an increase in reserve requirements on demand deposits.

Against the background of the worsening United States balance of payments deficit, the sterling devaluation and the ensuing burst of speculative buying of gold, the President announced on January 1, 1968 a stringent new programme to strengthen the balance of payments programme that had been in effect since 1965. It called for (1) mandatory limits on direct investment abroad by United States companies, (2) a further reduction in foreign credits from United States banks and other financial institutions, (3) deferment of non-essential American travel outside the Western Hemisphere, (4) a reduction in the foreign exchange cost of Government programmes overseas and of Government missions abroad and (5) measures to increase the United States trade balance. The new measures continue to shield the less developed countries by permitting direct United States investment and reinvested earnings to exceed the 1965-66 average by up to 10 per cent. They also make a distinction between, on the one hand, Canada, Britain, Japan, Australia and oil-producing countries—where this type of investment may equal 65 per cent of the 1965-66 average—and, on the other hand, other industrial countries on which a moratorium was placed on direct investment outflows. The objective of the programme as a whole is to achieve a $3 billion improvement in the balance on international transactions in 1968, bringing it close to equilibrium. The President has also asked Congress for prompt action to free approximately $10½ billion of gold now required as reserves against domestic currency in order to increase the amounts available to ensure the international convertibility of the dollar into gold at $35 per ounce.

In Britain the pound sterling remained under intermittent pressure through the spring and summer of 1967. A "neutral" budget was introduced in May and selective reflationary measures implemented through mid-year. Sterling began to come under severe pressure after the Middle East crisis and its par value was reduced by 14.3 per cent on November 18. Concurrently with devaluation, the Bank Rate was raised from 6½ per cent to 8 per cent, and the Government announced a series of deflationary measures. The objective is an improvement of at least £500 million a year in the balance of payments with a surplus in the second half of 1968 at an annual rate of at least £200 million. In mid-January additional measures were announced to reduce the growth in Government expenditure to an annual rate of 2.8 per cent in real terms over the next two fiscal years.

Germany continued the policy of monetary ease which had begun late in 1966 and the rediscount rate was lowered four times in the first half of 1967. An expansionary fiscal programme was put into effect early in the summer of 1967 and a larger public investment programme was announced in July. France also announced anti-cyclical fiscal measures in the spring and summer of 1967, but the stimulating effects were largely neutralized by subsequent tax increases designed to put the social security fund back into balance. Further important measures to stimulate the French economy were announced early in 1968 and Belgium has also introduced further reflationary measures. Italy and the Netherlands maintained relatively neutral financial policies, although in the latter country monetary conditions were allowed to ease in response to slackening labour market conditions. In Sweden monetary conditions eased in 1967, but following the devaluation of sterling the Swedish currency came under substantial pressure, which was effectively relieved by a temporary tightening in monetary policy. Other Scandinavian countries adopted policies of restraint in 1967 in an effort to slow the rise of wages and prices. The economic policies pursued in Japan were largely neutral until mid-year but increasing concern over the widening of the current account deficit and the devaluation of sterling led to the implementation of a more restrictive mix of policies toward the end of the year.

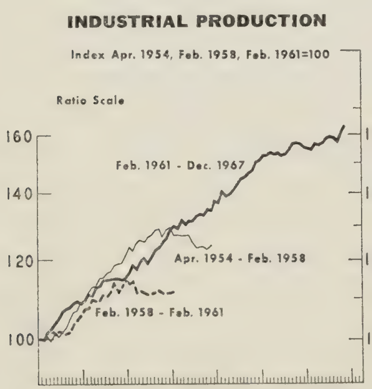
Economic Developments in Canada

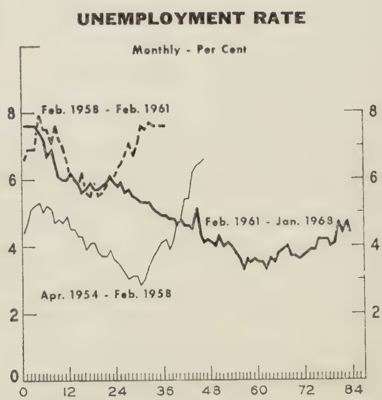
The period of adjustment in the Canadian economy which began in the spring of 1966, following several quarters of unsustainable rates of economic expansion, continued through most of 1967. Further increases in output and employment were achieved in the course of the year; indeed, some segments of the economy grew quite rapidly, particularly during the months most affected by Expo '67 and other Centennial activities. However, in a number of sectors output and employment were static or even declined. Consequently, the overall growth of the economy was slow, particularly by comparison with the high rates of expansion achieved during the five years prior to early 1966 when the economy was moving from recession to a state of considerable pressure on its resources. In 1967, despite the development of some slack in the economy, the cost, price and productivity trends which had emerged during the period of excessive demand remained sufficiently unfavourable to be matters for continuing concern.

From the spring of 1966, almost all major sectors of the economy contributed to the easing of demand pressure, with the major exception of the government sector which continued to increase its demands on the economy very rapidly, at least until late in 1967. Expenditures in the personal sector also continued to increase fairly strongly through this period, but spending on consumer durables was one of the earliest elements of demand to moderate. In the latter part of 1966 this was followed by a sharp decline in investment in new housing and in business inventories. During the spring and summer months of 1967, house-building activity recovered strongly and there was a considerable improvement in Canada's international balance of payments on non-merchandise account resulting from the heavy influx of foreign visitors and some reduction in travel abroad by Canadians because of Expo and other Centennial activities. However, these stronger elements of demand developed at a time when some other important sectors including business investment in plant and equipment and exports, particularly exports of wheat, were weakening. Towards year-end there were some signs of renewed strength, for example in exports, but the available current statistics present a somewhat more mixed

picture for Canada than for the United States. Through the year, indeed, the contour of economic activity in Canada differed more noticeably from that in the United States than is usually the case—perhaps partly because of such special factors as the differing impact of strikes in the two countries, the wave of tourist spending in Canada, and the influence of the war in Viet Nam on the United States economy. The resumption of quite rapid growth in the United States in the second half of 1967 and the expectation of even higher rates of expansion in the early part of 1968 has undoubtedly provided important support to the Canadian economy. The relatively stronger pace of economic activity in the United States than in Canada was probably a factor in the marked improvement which occurred in Canada's external trade balance in the last quarter of 1967.

One of the notable features of the economic situation in 1967 was the relatively moderate degree of the adjustment in the economy when viewed either in the perspective of the whole expansion or in comparison with earlier periods of adjustment. The charts below show the striking differences in the behaviour of two of the most important cyclical indicators between the recent period of adjustment and those which developed into recessions in 1960-61 and 1957-58. In contrast to the moderate declines in industrial production which occurred in these earlier periods, this index stayed on a slowly rising trend in 1966-67. While the unemployment rate drifted up through most of the period from the spring of 1966 to the end of 1967, the rise was small by comparison with the sharp increases which occurred in 1957 and 1960. The highest level recently reached was a seasonally adjusted rate of 4.7 per cent at year-end and the rate fell again to 4.4 per cent in January 1968.



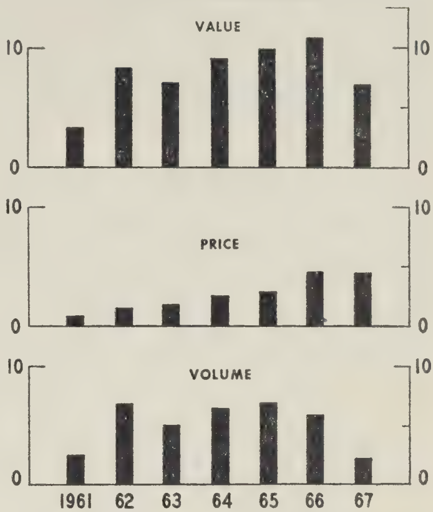


Months from reference-cycle low-point.
Seasonally adjusted.

TOTAL OUTPUT. Gross National Product at current prices rose considerably less in 1967 than in 1966. Prices increased about the same amount in both years, and a much smaller proportion of the increase in GNP represented a gain in real terms in 1967. The value of GNP is estimated to have been about 7 per cent higher in 1967 than in 1966; about 4½ per cent was the result of higher prices and only 2¼ per cent, or one third, represented higher real output of goods and services. In 1966 the increase in GNP was 10¾ per cent in money terms and almost 6 per cent in real terms.

GROSS NATIONAL PRODUCT

Annual Percentage Increase

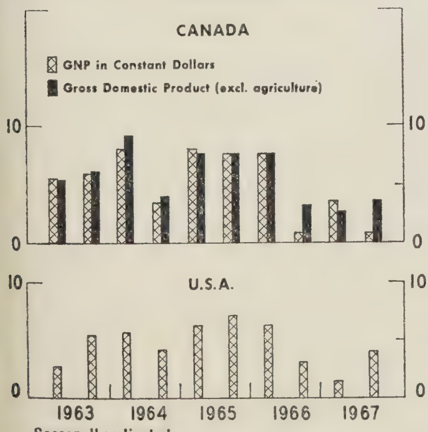


1967 includes estimate for fourth quarter.

A factor contributing to the slowing in the growth of output in 1967 was the smaller western wheat crop which, though above average in quantity and quality, was almost 30 per cent less than the record harvest of 1966. The reduction in the over-all growth rate should also be viewed in the context of the previous unsustainably large gains in non-farm output which had been achieved initially by taking up slack and later by pressing excessively on the economy's potential. In the event, the increase of about 3 per cent in non-farm real output in 1967 was only about half that of 1966.

REAL OUTPUT
ANNUAL RATES OF INCREASE
CANADA - U.S.A.

Half Year to Half Year Percentage Increase at Annual Rates



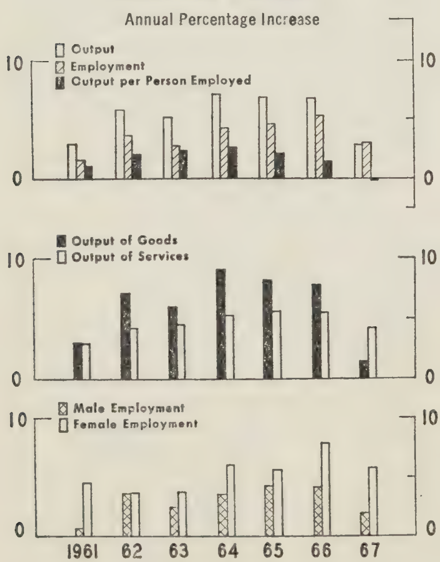
Seasonally adjusted.
Second half 1967 for Canada includes estimate for fourth quarter.

The adjustment in the rate of economic expansion, as measured by gains in real GNP, was more uneven in Canada than in the United States. Though the pace of expansion moderated considerably in both countries in the second half of 1966, the slowdown appears to have been more pronounced in Canada. In 1967 considerable differences developed in the course of GNP in the two countries; in the United States there was a very small gain in the first half of 1967 and a strong recovery in the second half,

while in Canada output according to this measure rose more strongly in the first half. However, the course followed by the index of gross domestic product, which to some extent serves as an alternative and largely independent measure of production in Canada, bore a much greater similarity to the pattern of United States economic activity, with more strength emerging in the second half of the year.

PRODUCTIVITY AND EMPLOYMENT. Virtually the whole increase in non-farm output in 1967 appears to have been achieved through higher employment with little or no increase in output per worker. In part, at least, the poor productivity performance during the year was a normal consequence of the slowing down in the growth of output. For instance, output per person employed tended to be limited in 1967 by a reduction in average hours of work. The available information indicates a fairly sharp decline in average hours worked per week in manufacturing and there was probably a similar tendency towards reduced overtime and more short-time work elsewhere in the economy. After allowing for hours worked, productivity in manufacturing is estimated to have increased about 1½ per cent in 1967; this was still considerably less than the below-average gain of 2½ per cent experienced in 1966. To some extent the performance in both years may have been affected by a reluctance on the part of employers to risk losing trained workers who had been acquired with difficulty during the earlier period of labour shortages.

OUTPUT, EMPLOYMENT AND PRODUCTIVITY NON-FARM ECONOMY



1967 output includes estimate for fourth quarter.

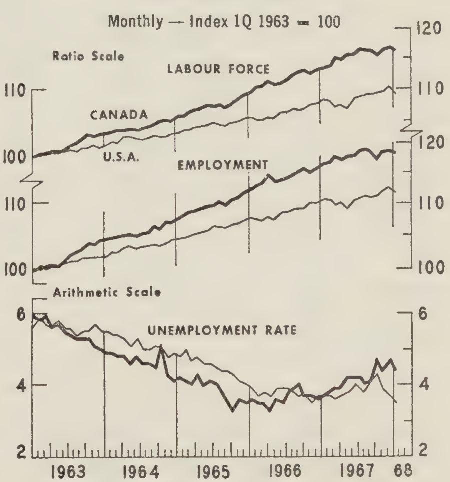
Another factor which probably influenced the economy's over-all productivity performance during 1967, and which is also not unusual during periods of adjustment, was the fact that the slowdown in the growth of demand had its main impact on the sectors of the economy producing goods as distinct from services. While the output of services also grew somewhat less rapidly in 1967 than in other recent years, the continuing relatively buoyant demand for services, reinforced by the unusual level of tourist activity, was an important sustaining force in the economy. Output of goods is estimated

to have risen by about 1½ per cent in 1967, roughly one fifth of the previous year's gain, while the output of services is estimated to have grown by over 4 per cent compared with about 5½ per cent in 1966. Since the production of goods tends to be capital-intensive and services labour-intensive, average output per worker is higher in goods-producing industries; consequently the change in the mix of output may well have had an adverse but temporary effect on the apparent trend of the economy's productivity.

The changes in the growth rates of the goods and services sectors also appear to be reflected in the labour market, where job opportunities for women expanded more than those for men. Although the increase in female employment has been more rapid than in male employment for a number of years, 1967 was the first year since 1961 in which women accounted for more than half the increase in non-farm employment. Seasonally adjusted adult male employment showed little increase after the beginning of 1967.

A rise of close to 1 per cent in the Canadian unemployment rate in the course of 1967 compares with no net change over this period in the United States rate. The greater increase in unemployment in Canada can be attributed to the much higher rate of increase in the labour force in Canada: the net increase in employment during the year was much the same in both countries. Virtually all of the growth in employment in Canada came in the first half of the year while employment in the United States was weak in the first half of the year and then rebounded strongly. On an annual average basis, Canada's labour force increased by just under 3¾ per cent in 1967 compared with almost 4 per cent in 1966 and 3 per cent in 1965.

LABOUR FORCE AND EMPLOYMENT
CANADA - U.S.A.



Seasonally adjusted.

In 1967 as in 1966, immigration was a factor contributing to the high rate of labour force increase. Total immigration, which had risen from about 150,000 in 1965 to just under 200,000 in 1966, amounted to almost 225,000 in 1967. The proportion of the population participating in the labour force also continued to rise, though less strongly than in the previous year. There was some decline in participation rates in the latter part of the year which was probably associated with the easier conditions in the labour market but possibly also reflected the withdrawal of people who had taken temporary jobs during the

tourist season. A rather striking change which occurred in the labour market in 1967, which may also have been symptomatic of less buoyant employment conditions, was an interruption of the decline in farm employment which had been going on for many years; indeed, in contrast to a decline of almost 8½ per cent in 1966, farm employment averaged about 2¾ per cent higher in 1967.

Regionally, as the table below indicates, there continued to be considerable variation in the rates of growth of labour force and employment across the country. The rise in unemployment rates in the course of the year was slightly greater in Quebec and British Columbia than in other regions. However, in Quebec this probably reflected to an important extent the aftermath of the especially rapid advance in employment experienced in the previous year when many projects were being rushed to completion in advance of Expo. British Columbia continued in 1967 to have a much larger growth in labour force to absorb than did other parts of the country.

REGIONAL LABOUR MARKETS

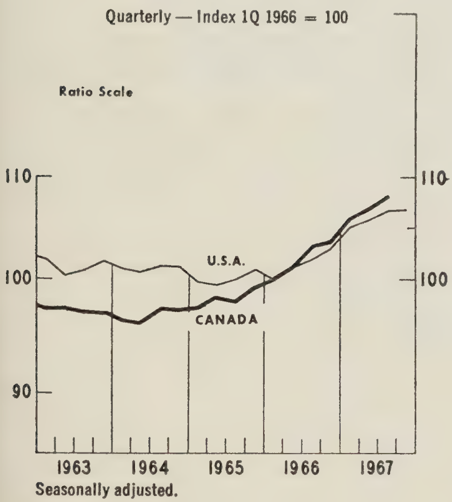
	Labour force		Employment		Unemployment			
	(annual percentage increase)				(per cent of labour force)			
	1966	1967	1966	1967	1966	1967	4Q/66(1)	4Q/67(1)
Atlantic.........	2.5	1.4	3.5	1.2	6.4	6.6	6.4	6.8
Quebec..........	4.6	3.8	5.4	3.2	4.7	5.3	4.6	5.8
Ontario..........	4.0	4.2	4.0	3.6	2.5	3.1	2.6	3.5
Prairies.........	1.6	1.5	2.2	1.3	2.1	2.3	2.2	2.8
B.C.............	6.6	7.3	6.1	6.6	4.5	5.1	4.8	5.8
Canada..........	3.9	3.7	4.2	3.2	3.6	4.1	3.7	4.6

(1) Seasonally adjusted.

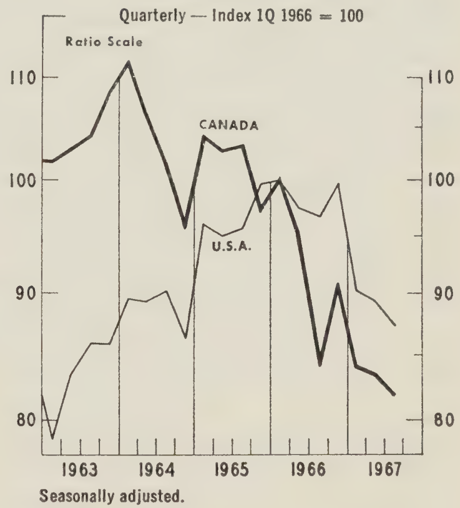
COSTS AND PRICES. Although the general easing of demands on the economy, including those in the labour market, may have begun to alter the underlying relationships and attitudes which had been contributing to the strong upward pressure on costs and prices, definite signs of this were slow to appear in 1967. Major wage settlements continued to provide, on the average, for annual increases in wage rates of at least 8 per cent—even allowing for some apparent slight moderation in the latter part of the year. This was substantially in excess of the comparable figure for wage settlements in the United States, though the latter rose to more than 5 per cent in 1967. Large salary increases were also common in 1967, including many in the public sector. As in the previous year, the increase in average earnings ran far ahead of the long-run average productivity improvement and even further ahead of the below-average

productivity gains actually experienced. In manufacturing, the increase in average hourly earnings from 1966 to 1967 was about 7 per cent and the rise in the wage and salary bill exceeded the productivity improvement by a sufficient margin to produce a further rise of about 5 per cent in labour costs per unit of output. As the chart below illustrates, the recent deterioration in Canada's labour cost position in manufacturing compared with that of the United States—while not inconsequential—has been small. Most of the loss of ground occurred in the course of 1965, before the United States also began to experience noticeably stronger wage and salary pressures. Moreover, as noted on page 7, Canada's recent cost experience must be viewed in the light of its relatively good performance over the somewhat longer run compared with most of its other major trading partners.

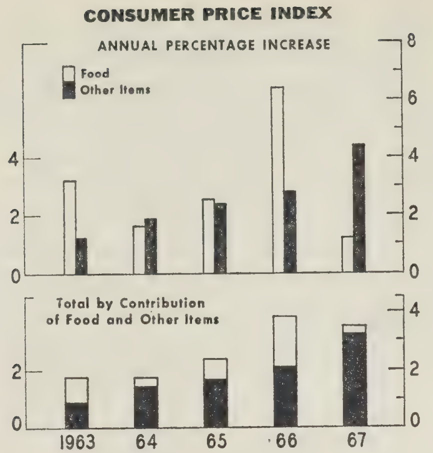
LABOUR COSTS PER UNIT OF OUTPUT IN MANUFACTURING CANADA - U.S.A.



PROFITS PER UNIT OF OUTPUT IN MANUFACTURING CANADA - U.S.A.

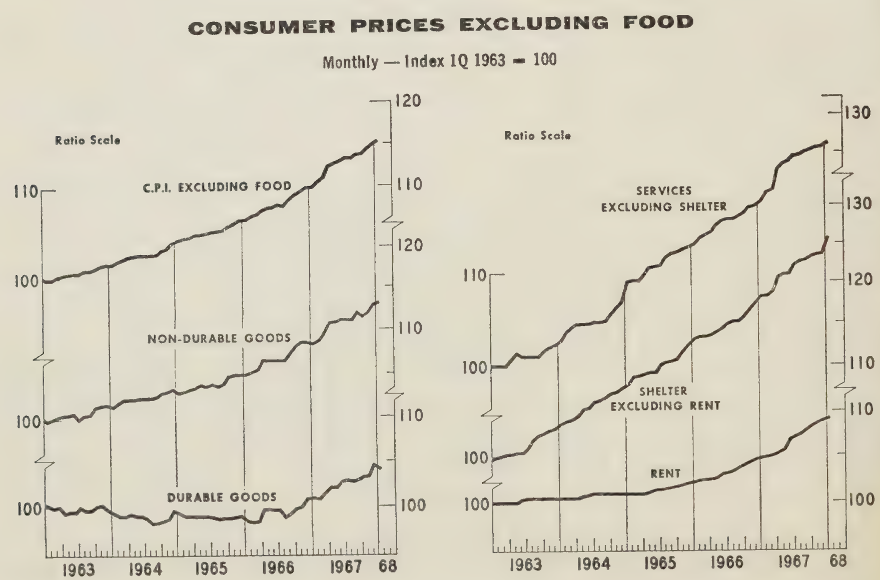


To a greater extent than in the United States, profit margins in Canada have served to absorb some of the impact of rising costs on prices. This is illustrated in the above chart on profits per unit of output in manufacturing. Nevertheless, prices continued to rise quite rapidly through most of 1967. The Consumer Price Index averaged 3.5 per cent higher in 1967 than in the previous year compared with an increase of 3.8 per cent in 1966. However, this slight moderation in the trend of the total index resulted from a much smaller increase in food prices in 1967 (just over 1 per cent) than in 1966 (almost 6½ per cent); excluding food, the CPI in 1967 averaged 4.4 per cent higher than in the



previous year compared with an increase of 2.8 per cent in 1966. Food prices too were again rising appreciably in the latter part of the year.

The underlying trend of non-food prices through the year was obscured to a significant degree by the effect of indirect taxes imposed at various times by the different levels of government. The federal government and several provinces increased their general sales tax rates in the first half of 1967 and this was an important factor in the high rate of price advance during that period. The rate of price increase was, on the whole, more moderate in the second half of the year. Prices of non-durable goods other than food were affected to some extent by the removal in September of the federal sales tax on pharmaceuticals; nevertheless, the underlying rate of price increase of non-durable goods remained high and was influenced by the imposition towards year-end of higher taxes on alcohol and tobacco. Durable goods prices rose strongly, by any recent standards, through the year. Some moderation of the rate of increase in service prices, which were little affected by tax changes, was evident in the second half



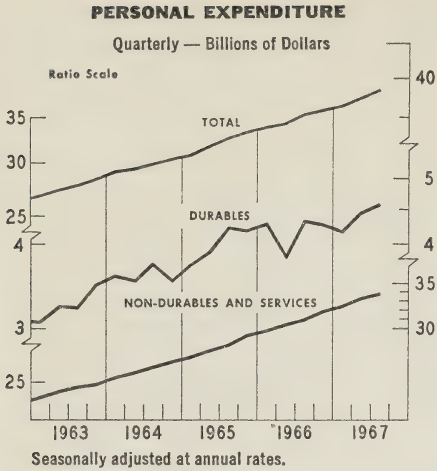
of the year; there had been a sizeable increase in some items including doctors' fees and urban transit fares earlier in the year. The rent index rose strongly in 1967, as did other shelter costs.

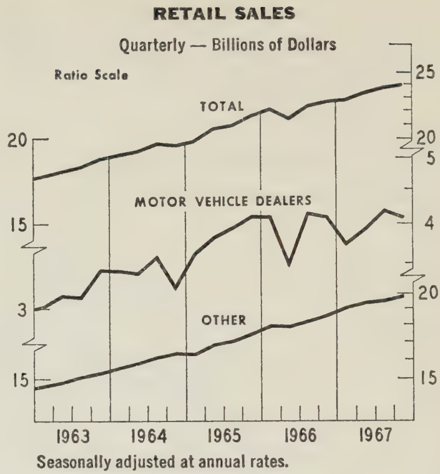
PRIVATE DOMESTIC DEMAND. Personal spending is estimated to have risen by about 8½ per cent in 1967, only slightly less than in the previous year. For the most part this reflected the continuing strong growth of incomes.

The increase in labour income (wages and salaries and supplementary benefits) was about 9½ per cent in 1967; though less than the huge increase of over 12½ per cent recorded in the previous year, this was still very large, both absolutely and in relation to the gain in employment. The number of wage and salary earners increased by about 3½ per cent in 1967 compared with a gain of about 6 per cent in 1966, but average earnings per worker continued to rise at close to 6 per cent per year. Personal income was also affected by the much smaller wheat crop harvested in 1967 than in 1966; net income of farm operators (including unrealized income in the form of inventories) declined by more than 10 per cent in 1967 compared with an increase of over 20 per cent in 1966.

The effects of these developments on disposable income in 1966 and 1967 were dampened by increases in payroll deductions of various kinds. Contributions to the Canada and Quebec Pension Plans began in 1966, and in 1967 personal income tax collections rose strongly as a result of the general increase of approximately 10 per cent in federal personal income tax rates at mid-1966 and the doubling of maximum individual Old Age Security contributions at the beginning of 1967. Personal disposable income increased by about 8 per cent in 1967 compared with a gain of almost 9½ per cent in 1966. There was some tendency in the latter part of the year for the ratio of personal saving to disposable income to decline from its previously high level.

The main trends in consumer spending in 1966 were extended into 1967, with purchases of durable goods such as cars, furniture, and appliances remaining relatively sluggish by comparison with the continued rapid increase in purchases of goods and services of a less lasting (and perhaps individually less costly) nature. Spending on durables is estimated to have risen by over 5 per cent in 1967, which was about 1 per cent more than the previous year's increase; in volume, however, the increase was about 1 per cent less than in 1966. Sales of new automobiles, which had declined about 2 per cent in 1966 following a rapid rise over several years, showed some signs of moderate recovery through the spring and summer months of 1967; however, they fell off again in the closing months of the year, partly it is believed because of supply problems caused by a strike in the United States and an associated curtailment of Canadian production. For 1967 as a whole, the number of new cars sold was down a



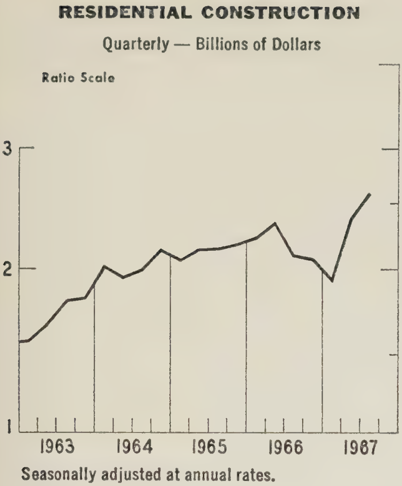


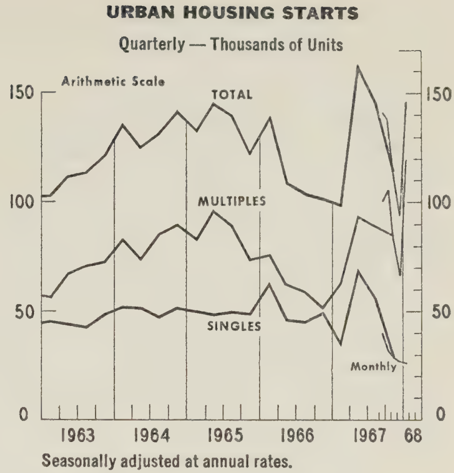
further 2 per cent. Sales of household and other durables strengthened somewhat in the early part of the year, but later levelled out. Consumer spending (other than on cars) appears to have been well maintained in the closing months of the year.

One of the highlights of 1967 was the recovery in housebuilding activity. Residential construction expenditures, which had fallen sharply in the second half of 1966, rose strongly in the course of 1967, and the annual level of expenditures is estimated to have been about 7 per cent higher in 1967 than in 1966.

Following an extended decline from about the middle of 1965 to near the end of 1966, housing starts picked up rapidly in the spring months of 1967 and fell off again later, for the special reasons explained below. Total starts in 1967 were some 20 per cent above the 1966 level and fell just short of the 1964-65 level of approximately 165,000 units. As was the case with the previous decline, most of the increase in starts in 1967 was in apartments and other multiple dwellings such as row-housing, which have traditionally been most dependent on private sources of financing. Starts of single family dwellings, which had been supported in 1966 by an increase in direct Government loans, were little changed in 1967; the number of units financed by Central Mortgage and Housing Corporation was about 10 per cent lower than in the previous year.

The over-all rise in housing starts in 1967 was undoubtedly in part a response to the general easing of credit conditions which occurred late in 1966 and early in 1967, as well as to the strong underlying demand for housing, but a number of important changes in the administration of the National Housing Act affected the pattern of activity through the year and in particular contributed to





the high level of starts in the spring. In November 1966 the maximum interest rate on NHA insured mortgage loans was fixed at 7¼ per cent with the understanding that beginning in 1967 the rate was to be adjusted automatically at the end of each quarter to a level of 1½ per cent above the average yield on long-term Government of Canada bonds. When, towards the end of the first quarter, it became evident to lenders that the rate would come down to 7 per cent on April 1, there was a sharp increase in private lending activity under the NHA. In addition, at the beginning of 1967 the Government announced a special programme of direct CMHC loans to builders for the spring months. As a result of these influences and the fairly sizeable recovery in conventional lending activity which occurred early in 1967, housing starts, both single and multiple, rose very sharply in the spring. Multiple starts remained at a high level until late in the year when the tighter mortgage market conditions which had developed again in the course of the summer began to have their impact. Single starts also dropped to a much lower level. In view of the large financial resources already committed by Government and the need to conserve its funds to a greater extent for low-income housing, the Government took further action in September to stimulate the flow of private mortgage money. The quarterly adjustment formula was altered to establish the maximum NHA rate at a level of 2¼ per cent above the long-term Government of Canada bond average, the widest spread permitted by the Act, with the intention of allowing the actual rate to be set by market forces within this limit. Under the formula, the maximum rate became 8¼ per cent on October 1 and 8⅝ per cent on January 1, 1968. There was a renewed sharp increase in NHA approved lending by private institutions in the closing months of the year, with most of

the loans made at a rate lower than the permitted maximum. This lending should have an important influence on the trend of starts in the early months of 1968; indeed, a rebound of starts occurred in January.

Despite the increase in mortgage lending and the consequent rise in housing starts in 1967, the number of housing units completed, 150,000, was about 8 per cent less than the 1966 total. Completions were below most estimates of current housing requirements; there was a significant further tightening in the housing market in 1967, reflected in sharp increases in the prices of new and existing houses and in rents, particularly in certain large metropolitan areas. While the number of dwellings under construction at the end of 1967 was substantially higher than a year earlier, rapidly rising land values and servicing costs, together with the problems associated with providing an increased supply of mortgage funds, were matters of continuing widespread concern.

The large wave of business investment in plant and equipment which began to gather force early in 1963 reached a crest early in 1967. In the first quarter of 1967 investment was running at a level which in value terms was almost double what it had been four years earlier; even after allowing for the substantial rise in machinery and construction costs over this period, the level of investment had increased by almost two thirds.

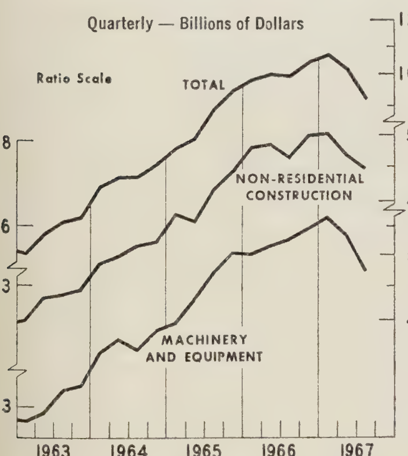
The investment boom started to moderate in 1966. Although the increase in outlays in 1966 was not far below the 20 per cent increase of the two previous years, some tapering off appeared in the course of the year. A number of important restraining forces came into play. An important aim of public policy (reflected, for example, in the 1966 budget) was to restrain investment to a rate more consistent with the economy's potential rate of growth; the increased productive capacity in some industries was sufficient for the time being; and as a result of tighter credit conditions and a squeeze on the internal generation of funds, financial considerations were less conducive to continued high rates of expansion. Corporate profits, which had been rising strongly, flattened out in the latter part of 1965, and with some fluctuations declined until early 1967. Total profits appear to have risen moderately thereafter, but for the year as a whole were about 5 per cent less than in 1966. The decline in profits per unit of output in the past two years was more pronounced, especially in manufacturing.

By the early months of 1967 little doubt remained that the end of the investment boom was at hand. The official investment intentions survey made at the turn of the year suggested that the 1967 level of investment would be very little higher than in 1966. Prompt steps were taken to reverse the measures of restraint which had been aimed at business capital investment. In March the Government discontinued collection of the refundable tax on corporate cash

flow and terminated the period during which new capital expenditures would be subject to reduced rates of capital cost allowance. This was followed in the June 1967 budget by the removal of the remaining 6 per cent federal sales tax on production machinery and equipment; in the March 1966 budget this tax had been reduced from 11 per cent to 6 per cent effective April 1, 1967 but full removal had not been scheduled until April 1, 1968. (Later developments in the Government's fiscal policy are referred to on page 40.)

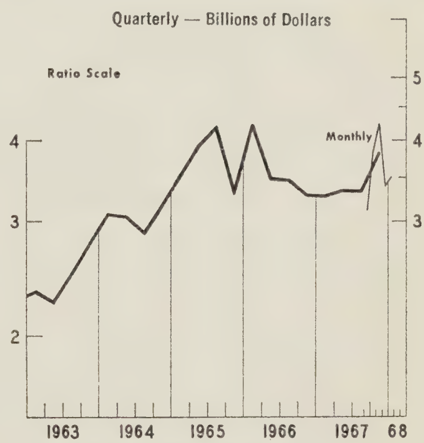
In the event, a fairly marked decline in business investment occurred in the course of 1967, though the annual level was apparently not much below that of the previous year. Figures for the last quarter are not yet available, but the underlying trend was probably not as weak as suggested in the chart below. In the second and third quarters non-residential construction was adversely affected by strikes in southern Ontario, and the removal of the federal sales tax was reflected in the dollar value of outlays on machinery and equipment. The general expectation at year-end seemed to be that the annual level of investment in 1968 would not be much different from that of 1967. Non-residential contract awards showed some recovery late in 1967.

BUSINESS FIXED INVESTMENT



Seasonally adjusted at annual rates.

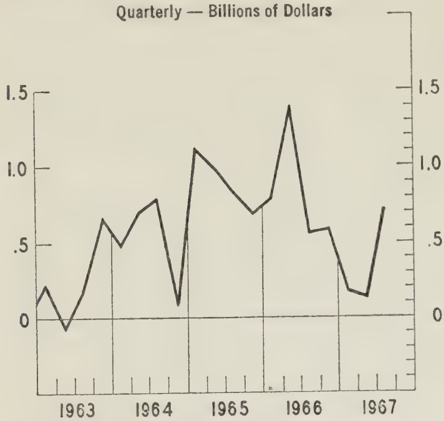
NON-RESIDENTIAL CONTRACT AWARDS



Seasonally adjusted at annual rates.
Source: Southam Building Guide.

Some of the factors which affected business investment in plant and equipment may also have contributed to the sharp reduction in the rate of business inventory investment. Between the second quarter of 1966 and the second quarter of 1967, this development exerted a brake on the rate of economic expansion equivalent to about 2 per cent of GNP. More than half of the adjustment was concentrated between the second and third quarters of 1966 and reflected to an important extent the development and subsequent correction of

INVESTMENT IN BUSINESS INVENTORIES



Seasonally adjusted at annual rates.

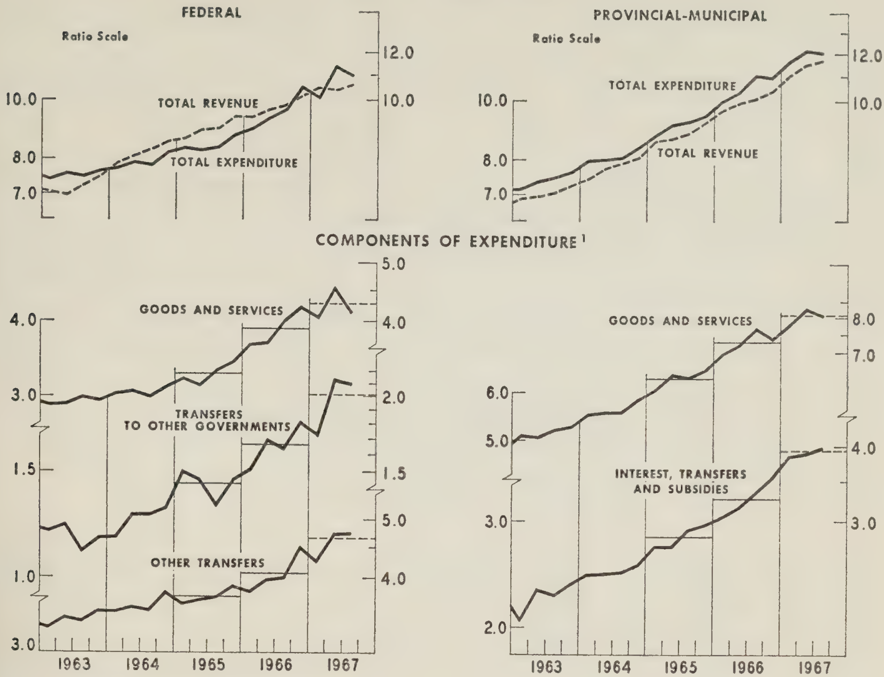
a temporary imbalance between production and sales of new cars. Apart from this, however, there was a fairly general and significant adjustment to lower rates of accumulation of inventories over the period, which was however milder than the concurrent adjustment of inventories in the United States. In the third quarter of 1967, total inventory accumulation increased again in both Canada and the United States, though at the manufacturing level in Canada some adjustment appears to have continued through the second half of the year.

GOVERNMENT SECTOR. Expenditures on goods and services by all levels of government combined continued to rise in 1967 but, except for the second quarter, at a somewhat slower pace than in 1966. Higher wage and salary outlays were the main cause of the increase; capital spending by provinces and municipalities, a major element in the growth of government expenditure in recent years, appears to have abated. Including transfer payments, however, the rise in total government expenditures was almost as rapid as in 1966. Transfers to the personal sector were up by 20 per cent due to expanded federal Old Age Security benefits and higher provincial grants to universities and hospitals. The final economic effects of these particular transfers are very similar to direct government expenditure on goods and services.

Total government revenues rose by 11 per cent during the year, slightly more than in 1966, but more slowly than expenditures. As a result, the combined deficit of all governments on a National Accounts basis (excluding Canada and Quebec Pension Plan receipts) increased by almost $350 million in 1967. A modest reduction in the provincial-municipal deficit was outweighed by the swing in the federal government's position. Changes in federal-provincial financial arrangements were an important factor explaining these movements in 1967. Higher abatements of federal personal and corporate taxes to the provinces and larger direct payments to the provinces for equalization and for the new post-secondary education programme were sources of new revenue to

GOVERNMENT REVENUE AND EXPENDITURE
National Accounts Basis

Quarterly — Billions of Dollars



Seasonally adjusted at annual rates.

1. Horizontal lines represent annual totals; 1967 includes estimate for fourth quarter.

the provinces and without them the provincial-municipal deficit would likely have increased.

Federal government revenues in 1967 increased at the same rate as in 1966 with increased receipts from the Old Age Security Tax change being offset by higher tax abatements to the provinces and by the effect on corporate tax liabilities of reduced profits. Combined provincial-municipal revenues rose by 15 per cent in 1967 reflecting the increased abatements and federal transfers already mentioned and also higher sales tax rates in a number of provinces. In addition to the above sources of revenue, the Canada and Quebec Pension Plan collections amounted to more than $700 million in 1966 and $900 million in 1967; these funds were available to the provinces to help finance their expenditures and their lending activities.

In addition to their increased expenditures, governments at all levels made larger net loans and advances to their own enterprises and to the private sector in 1967. (These loans are discussed in more detail on page 60.) As a

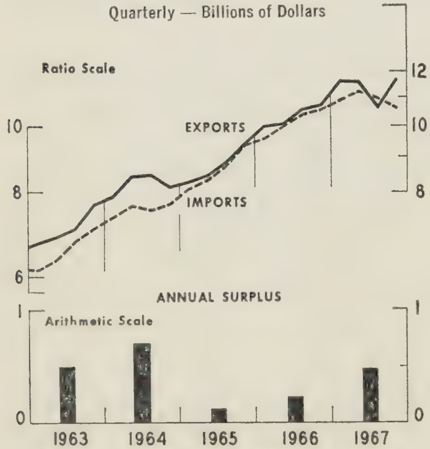
consequence, the over-all financial requirements of the government sector were much higher than in 1966.

In December 1966 the Government introduced a supplementary budget providing for increases in the Old Age Security Tax on personal income and in the manufacturer's sales tax to offset the expenditure effects of the supplementary old age pension programme. In the June 1967 budget some sales tax and tariff reductions were made with a view to lowering costs and prices in certain areas but no major changes in tax rates were introduced. In November the Government presented fiscal proposals which had the objective of moderating upward pressures on prices and interest rates by reducing the Government's cash requirements from about $1,500 million in fiscal 1967/68 to less than $750 million in the coming fiscal year. In a preliminary statement on November 10 the Minister of Finance announced that the Government intended to hold the increase in its expenditures on a budgetary basis (apart from medicare expenditures and the write-off of the Expo deficit) to 4½ per cent in fiscal 1968/69. This compares with an increase of about 12 per cent in the current fiscal year. In the supplementary budget introduced on November 30 the Government proposed additions to tax revenues aggregating $570 million.

CURRENT ACCOUNT OF THE BALANCE OF PAYMENTS. The merchandise trade balance improved in 1967. Canadian exports were remarkably buoyant, considering the less favourable external environment, and the easing in domestic demand, especially for machinery and equipment, resulted in a smaller rise in imports than in the previous year. Merchandise exports rose by 10 per cent in 1967 following an 18 per cent increase in 1966, while imports rose by 8 per cent, compared with a 17 per cent increase in 1966. The trade surplus rose from $224 million in 1966 to $480 million in 1967. Higher export prices contributed less to the increase in the value of exports in 1967 than in 1966; prices rose by 2 per cent compared with 4 per cent in 1966. Import prices rose by 1 per cent in each year.

MERCHANDISE TRADE

Quarterly — Billions of Dollars



Balance of payments basis; seasonally adjusted at annual rates.

Two special factors must be noted in comparing merchandise exports and imports in 1967 with earlier years. First, the Canada-United States Automotive Agreement signed in January 1965 encouraged a greatly increased flow of

two-way trade in new parts and completed automobiles and trucks. The pattern of trade in automotive products was distorted in the latter part of 1967 by a strike in the United States and, as a result, on a seasonally adjusted basis Canadian exports rose and imports fell in the final quarter of the year. The table below shows that the automotive trade deficit declined from a peak of $800 million in 1965 to about $650 million in 1966 and to about $500 million in 1967.

The second special factor relates to exports of wheat and flour. These have fluctuated appreciably from year to year, with the changes mainly due to variations in the size of Canadian sales to Eastern Europe and Asia. The decline in the value of wheat and flour shipments from $1,135 million in 1966 to $778 million in 1967 was largely accounted for by a fall in the volume of exports to these markets in the second half of the year and by the decline in world wheat prices.

MERCHANDISE TRADE(1)

(millions of dollars)

	1964	1965	1966	1967(2)
Automotive products				
Exports	190	368	1,010	1,753
Imports	849	1,169	1,664	2,250
Balance	−659	−801	−654	−497
Wheat and flour				
Exports	1,093	921	1,135	778
All other commodities				
Exports	6,955	7,456	8,181	8,854
Imports	6,688	7,458	8,438	8,655
Balance	267	− 2	−257	199
Total				
Exports	8,238	8,745	10,326	11,385
Imports	7,537	8,627	10,102	10,905
Balance	701	118	224	480

(1) Adjusted to balance of payments basis.
(2) Preliminary estimates.

Exports of commodities other than wheat and flour and automotive products increased by more than 8 per cent in 1967 compared with nearly 10 per cent in 1966. The reduction in the rate of increase was concentrated in shipments to the United States and Continental Europe where industrial activity

was less buoyant than in 1966. Exports to overseas countries other than Continental Europe increased considerably more rapidly than in the previous year. Canada's total exports to the United States grew more rapidly than total United States imports, with much of the gain concentrated in automotive products. Exports of other commodities to the United States rose by 6 per cent in 1967 about half the 1966 rate but more than the rate of increase in total United States imports of commodities other than automotive products.

Canada's exports were, of course, also affected by economic developments in the major overseas countries, which are described earlier in this Report. Rising demand in Japan was reflected in a remarkable growth in Canadian exports to that country, mainly of base metals, farm and forest products; Canada's share of total Japanese imports increased. Shipments to Britain of commodities other than wheat rose at about the same rate as Britain's total imports. On the other hand, Canadian exports to Continental European countries declined slightly while the total imports of the group rose, so that Canada's share of this market declined.

CANADIAN EXPORTS EXCLUDING WHEAT AND FLOUR(1)

	Value (millions of dollars)		Percentage change from previous year	
	1966	1967 (11 months)	1966	1967(2)
To: United States	5,477	6,430	25	17
(excluding automotive products)	*(4,758)*	*(5,023)*	*(12)*	*(6)*
Britain	892	942	− 4	6
Continental Europe	715	708	8	− 1
Japan	271	428	29	58
Australia, New Zealand, South Africa	204	233	−11	14
All other countries(3)	558	619	12	11
Total	8,117	9,360	17	15

(1) Trade of Canada basis. Excludes re-exports.
(2) Change from first 11 months of 1966 to first 11 months of 1967.
(3) Mainly less developed countries and Eastern Europe.

The reduced rate of growth in Canadian exports in 1967 was shared by most forest products and manufactured goods, and some metals and minerals. Notable exceptions were exports of aircraft and oil and gas, which recorded much larger increases than in the previous year. Shipments of lumber, aluminum, nickel and zinc also rose more rapidly in 1967 while shipments of copper continued to record a substantial increase, though not as large as in 1966.

Canadian merchandise imports other than automotive products rose by only 3 per cent in 1967, compared with a 13 per cent increase in 1966. Imports of transportation equipment and consumer goods other than food rose almost as rapidly as in 1966; imports of machinery rose little after several years of rapid increases; and imports of industrial materials, construction materials and food did not rise at all.

CANADIAN IMPORTS CLASSIFIED BY END-USE(1)

	Value (millions of dollars)		Percentage change from previous year	
	1966	1967 (11 months)	1966	1967(2)
Fuels and lubricants	604	622	5	3
Industrial materials	2,310	2,294	8	−1
Producers' equipment	2,370	2,441	19	3
Construction materials	285	279	−1	−2
Transportation equipment(3)	325	399	25	23
Food	671	681	8	1
Other consumer goods	868	988	17	14
Special items	304	256	23	−16
Sub-total	7,737	7,960	13	3
Automotive products	1,463	2,030	42	39
Total	9,200	9,990	17	9

(1) Trade of Canada basis.
(2) Change from first 11 months of 1966 to first 11 months of 1967.
(3) Excluding automotive products.

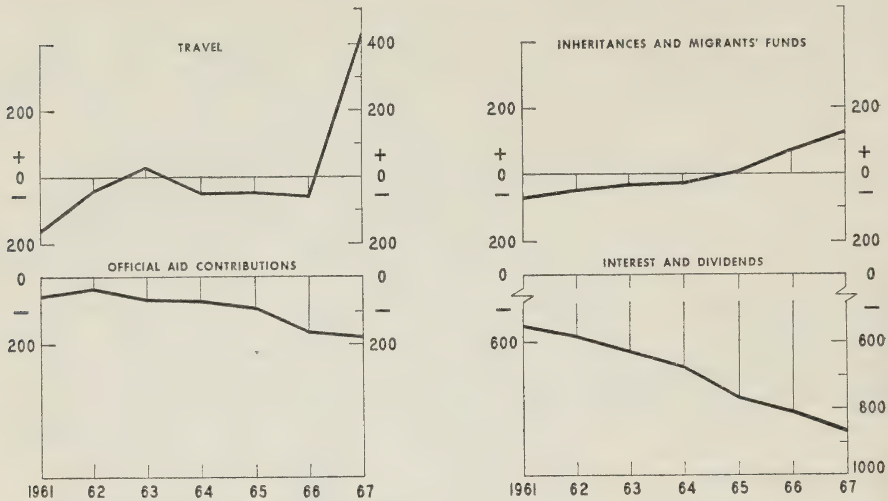
The trade balance in commodities other than wheat and flour and automotive products, which had worsened in 1965 and 1966, improved by about $450 million in 1967 and returned to a surplus. (See the table on page 41.) This improvement was concentrated largely in our trade with the United States, Britain and Japan. Demand for Canadian exports in these and other overseas countries outside Europe rose at a time when Canadian demand for imported machinery and industrial materials was showing little growth.

The increase in total merchandise exports and imports in 1967 was concentrated in the first half of the year. Both exports and imports declined in the third quarter, exports largely because of the sharp drop in wheat shipments and imports because of reduced demand for a broad range of imported goods. Exports picked up again in the fourth quarter, reflecting substantial increases in shipments of automotive products and copper, while imports continued to decline and the merchandise trade balance swung from a deficit to a large surplus.

Canada's international deficit on non-merchandise transactions fell from $1,361 million in 1966 to $905 million in 1967. Thanks to sharply increased

NON-MERCHANDISE ACCOUNT - SELECTED BALANCES[1]

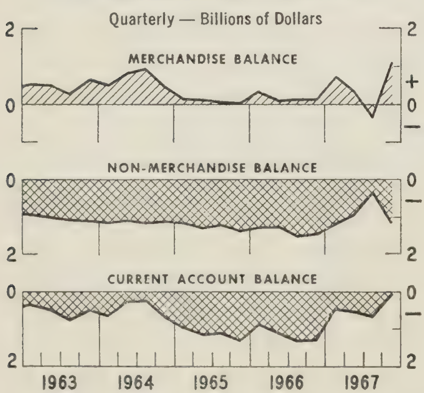
Annual — Millions of Dollars



1. Net receipts above the zero line; net payments below.

expenditures of foreign tourists attracted to Canada by Expo '67 and other Centennial year activities the travel balance swung from a deficit of $63 million in 1966 to a surplus of $427 million in 1967. Also contributing to the reduced deficit was a further improvement in the balance of inheritances and migrants' funds. On the other hand, a growing deficit on interest and dividend account served to offset part of the other gains.

CURRENT ACCOUNT OF THE BALANCE OF PAYMENTS



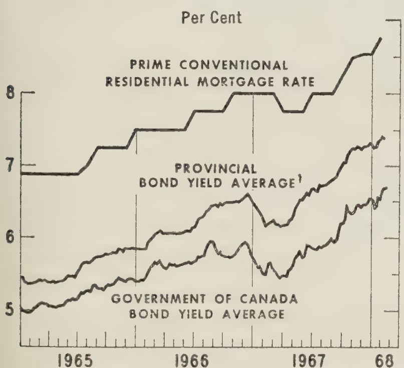
Balance of payments basis; seasonally adjusted at annual rates.

Canada's total current account deficit declined from $1,137 million in 1966 to $425 million in 1967. Current account transactions with the United States resulted in a sharp reduction in the deficit, from $2,142 million in 1966 to $1,410 million in 1967, because of travel receipts connected with Expo and a reduction of the merchandise trade deficit. The surplus with other countries was little changed from 1966 despite the decline in wheat exports, primarily because of higher trade balances with Britain and Japan and larger receipts from overseas travellers visiting Canada.

Financial Developments in Canada

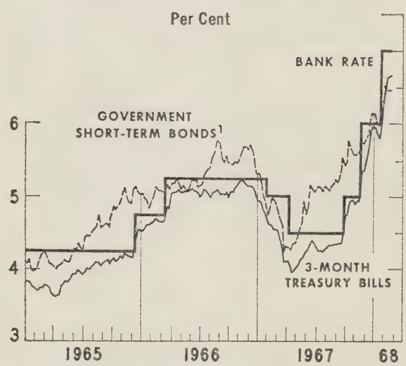
After a brief period of declining interest rates in the opening months of 1967, the trend toward higher interest rates was resumed in April and continued into 1968 even though there was a very substantial increase during the year in holdings of money and other liquid assets. The renewed rise in interest rates was particularly marked for long-term bond yields and mortgage rates; by early summer these had moved up to and beyond their previous peak levels of late 1966. The rise in rates in the short-term market was more gradual and it was not until late in the year that the levels prevailing in the latter part of 1966 were penetrated.

LONG-TERM INTEREST RATES



1. Average weekly yield on the 10 provincial bonds included in the monthly series published by McLeod, Young, Weir and Co. Ltd.

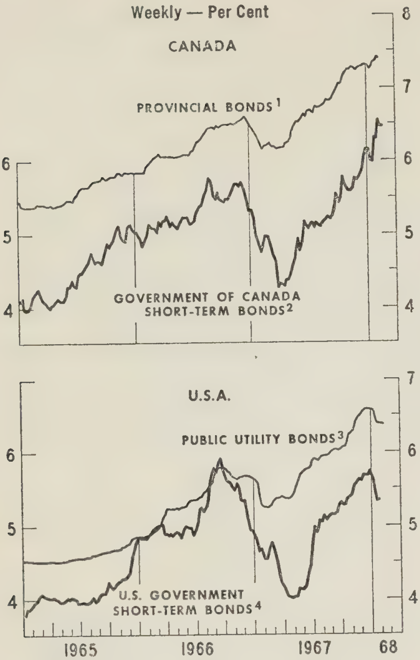
SHORT-TERM INTEREST RATES



1. Average weekly yield on Government of Canada bonds with a maturity between 3 months and 3 years.

The behaviour of interest rates in Canada during the year was similar in many respects to that of interest rates in the United States. From early spring onward, investors in Canada and in the United States appeared reluctant to commit funds at their disposal to long-term investments at prevailing rates of interest. Among the considerations influencing them were the sharp prospective increase in the demand for funds by governments, the expectation of an early pick-up in the pace of economic activity, and increasing anxiety about rising costs and prices. Interest rates rose to extremely high levels in Canada even

INTEREST RATE STRUCTURE
CANADA - U.S.A.



1. Average yield on the 10 provincial bonds included in the monthly series published by McLeod, Young, Weir and Co. Ltd.
2. Average yield on Government of Canada bonds with a maturity between 3 months and 3 years.
3. Moody's Investor's Service Inc. average yield on public utility bonds.
4. Average yield on U.S. Government bonds with a maturity between 9 months and 12 months.

though the central bank, wishing for both domestic and external reasons to avoid an excessive tightening of credit conditions, permitted a rapid expansion of the banking system and increase in liquidity. The growth of banks—and of other financial institutions—in 1967 was also unusually large in the United States, where the monetary policy followed was broadly similar to that in Canada. A special element in the situation in Canada was the improved competitive position of the chartered banks relative to other financial institutions under the revised Bank Act which came into force in May 1967. In the last months of 1967 and first months of 1968 the rate of monetary expansion in Canada slowed down markedly and interest rates—particularly short-term rates—rose sharply.

Canadian borrowers raised considerably more funds from private financial institutions and markets in 1967 than in 1966. All levels of government substantially increased their borrowings to help finance their rising expenditures and lending activity. Business borrowing rose in spite of some reduction in investment outlays on new plant and equipment and in additions to inventory; part of the funds borrowed were used to rebuild business holdings of liquid assets. Mortgage loans approved by private lending institutions to finance new residential construction also increased substantially.

At the beginning of 1967 it was becoming widely recognized that the Canadian economy, like that of the United States, was in the midst of an adjustment period in which expenditures on durables and housing had slackened off and businessmen were attempting to reduce their inventory levels. The Bank of Canada provided the banking system with relatively generous cash reserves in December 1966 and January 1967, and the view developed that the peak of interest rates had been passed. The average yield on long-term Canada bonds fell from a peak of almost 6 per cent in December to 5½ per cent at the beginning of February and varied around that level until mid-April. Long-term bond yields also fell sharply in the United States market where the lows for

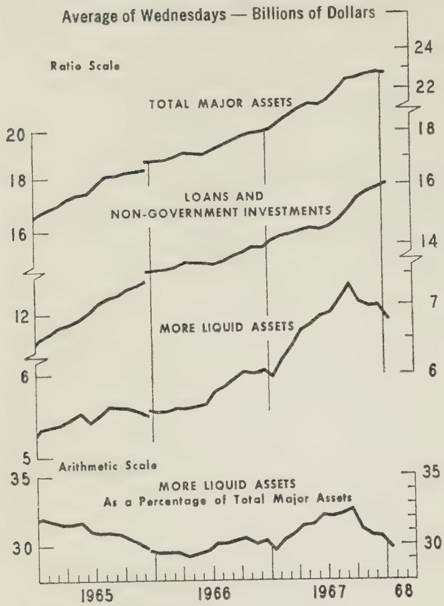
the year were reached in mid-January. Short-term money market rates fell even further and over a longer period in both countries, but especially in the United States. In Canada, the three-month treasury bill rate fell by almost 1¼ per cent from its peak in November 1966 to a level of 4 per cent at the end of April. The Bank Rate was reduced from 5¼ to 5 per cent at the end of January and by a further ½ per cent on April 7. On both occasions the announcement of the change indicated that the move reflected acquiescence by the central bank in the lower levels of market rates. Beginning in March the Bank tightened the cash reserve position of the chartered banks somewhat in order to reduce the rate at which they were adding to their holdings of liquid assets.

By April, as the outlook for economic activity strengthened (particularly in the United States) and it came to be generally felt that the period of adjustment would not be protracted, investors and borrowers began to revise their views of the financial outlook. Investors became increasingly aware that a very substantial rise in new offerings of government securities was in prospect in both countries. The possibility of a resurgence of demand pressures and of a return to the tighter monetary conditions experienced in 1966 were also probably important factors in the growing reluctance of investors to make long-term investments at prevailing interest rate levels. These expectations led lenders to prefer interest-bearing deposits and other short-term investments in anticipation of higher long-term yields later in the year. The result was that in spite of a rapid rate of monetary expansion long-term interest rates began to rise in April. By the end of the second quarter long-term rates were close to their peak levels of 1966 and the rise continued through the rest of the year.

Short-term money market rates began to rise in Canada in mid-April, somewhat earlier than in the United States, and rose quite sharply until the end of the second quarter; after levelling off during July and August they rose strongly again through early 1968. Even so, short rates (which had fallen further than long rates at the beginning of the year) remained below their 1966 peak levels until well into the fourth quarter, and for most of 1967 there was a larger differential between short and long rates than had existed in 1966. As a result, the scope for profitable operations by deposit-taking institutions continued to provide an avenue of relief from the congestion and high cost of borrowing in securities markets.

By continuing to permit a significant rise in the liquid asset holdings of the banking system, the Bank of Canada's operations from April until late summer helped to moderate the upward pressure on interest rates. The seasonally adjusted ratio of more liquid assets to total chartered bank assets rose from the low level of 29.6 per cent in January to 32.6 per cent in September. In addition, the Bank made supporting purchases in both the bill and bond markets during the second quarter. After mid-year the growth of bank loans

CHARTED BANK ASSETS[1]



Seasonally adjusted.
1. Breaks in the series reflect revised treatment of general reserves held against losses on loans and other assets.

accelerated, and given the prospect of some revival of demand strength and no slackening of the upward pressures on costs, the Bank of Canada began in September to slow down the expansion of the banking system, allowing the growth in bank loans to put significant pressure on bank liquidity. The more liquid asset ratio declined steadily from its September peak to 29.7 per cent in January 1968. Short-term money market rates rose sharply. The Bank Rate was increased by ½ per cent effective September 27 to a level of 5 per cent and to 6 per cent effective November 20, immediately following the devaluation of sterling. On January 21, 1968 the Bank announced that in the light of recent developments in the exchange market the Bank Rate was being raised to 7 per cent. By the end of February yields on Government of Canada securities through all maturities from 91-day treasury bills to long-term bonds were in a range from 6½ to 7 per cent.

Operations by the Bank of Canada in Government of Canada securities during each month of 1967 are summarized in Appendix Table I. A net amount of $233 million of securities was acquired over the year in market transactions, and other transactions resulted in a further net increase of $101 million in the Bank's portfolio of Government securities. The growth in the main assets and liabilities of the Bank are summarized in Appendix Table II. This growth was influenced by the changes in the banking legislation which gradually lowered the minimum cash reserves that must be maintained by the chartered banks. Beginning in July 1967 the reserve required against demand deposits was increased by ½ per cent each month while the reserve against other deposits was decreased by ½ per cent each month. By February 1968, when the new statutory ratios of 12 per cent against demand deposits and 4 per cent against other deposits were reached, the average required cash ratio had dropped from 8 per cent to 6.5 per cent, involving a required level of chartered bank deposits at the Bank of Canada which was $335 million lower than it would have been under the former minimum ratio. This meant that over the eight-month period the Bank of Canada had to withdraw significant amounts

of excess reserves from the banking system at a time when the scope for temporarily supplementing open market operations by transferring Government balances from the chartered banks to the central bank was limited by the low level of those balances.

From time to time during 1967 the Bank engaged in temporary swaps of foreign currency assets with the Exchange Fund Account in order to adjust the level of Government of Canada Canadian dollar cash balances at the Bank of Canada for day-to-day cash management purposes. In addition to remaining in continuous contact with securities markets and participating in the weekly treasury bill tender, the Bank made purchases or sales of Government of Canada securities in the market on about 100 business days in 1967. At the end of October the Bank arranged, for cash reserve management purposes, special short-term sale and repurchase transactions in treasury bills with the chartered banks at Bank Rate.

Bank of Canada advances to banks were outstanding on 24 business days during 1967 compared with 5 business days in 1966. The daily average for the year was $1.1 million compared with $.06 million in 1966. The Bank held securities under purchase and resale agreements with money market dealers on 72 business days during the year compared with 48 days in 1966. The daily average for the year was $7.6 million compared with $3.7 million in 1966.

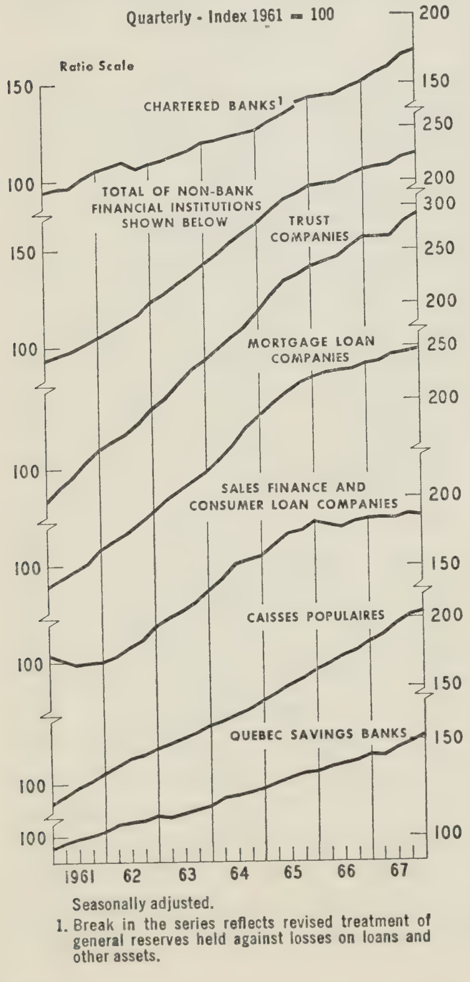
The Bank of Canada has informed the chartered banks how it will make use of two new powers granted to it by Parliament in the 1967 amendments to the Bank of Canada Act and the Bank Act. Effective May 1968 the banks will be required to maintain their statutory cash requirements on a semi-monthly instead of a monthly averaging period. Effective March 1968 the banks will be required to maintain secondary reserves (cash in excess of statutory requirements, treasury bills and day-to-day loans) equivalent to 6 per cent of their Canadian dollar deposits, with the ratio raised to 7 per cent in April.

The reasons for preferring the twice-monthly averaging period were outlined in the Bank of Canada submissions to the Porter Commission and in its oral evidence. Briefly, a shorter averaging period should lead to more sensitive chartered bank response to the central bank's cash reserve management.

The statutory secondary reserve ratio merely replaces a similar arrangement that has been in effect by agreement since 1956 and is being continued by agreement at the 7 per cent rate until this rate becomes effective on a statutory basis. The present circumstances have not been regarded as appropriate ones in which to do away with the secondary reserve requirement, and since the Bank has been given the legal power to require that a secondary reserve ratio be maintained it has seemed preferable to use this power rather than to seek to continue the arrangement by agreement.

CHARTERED BANKS AND OTHER FINANCIAL INSTITUTIONS. The policies and operations of the chartered banks in 1967 were influenced by the major changes in banking legislation which came into force on May 1. The interest rate ceiling on loans was raised to 7¼ per cent for the remainder of 1967 and removed altogether as of January 1, 1968, and the banks were empowered to originate mortgage loans at current rates of interest. The banks were also empowered to issue debentures with an original term to maturity of at least five years which are not subject to cash reserve requirements. Deposit insurance legislation was enacted early in 1967, under which deposits at chartered banks and other depository institutions are insured up to an amount of $20,000. Most deposit-taking institutions are required to have this insurance and to submit to inspection.

MAJOR CANADIAN ASSETS OF SELECTED FINANCIAL INSTITUTIONS



Seasonally adjusted.

1. Break in the series reflects revised treatment of general reserves held against losses on loans and other assets.

The chartered banks, operating aggressively under the terms of the new Bank Act, attracted a somewhat increased share of the flow of savings at the expense of competing institutions. They introduced non-chequable savings accounts bearing a 4½ per cent interest return (later raised to 5 per cent) and other new types of fixed-term deposits with life insurance or other novel features. It has become increasingly common in recent years for banks and other deposit-taking institutions to respond to cash drains by offering higher deposit rates in order to attract additional savings inflows as an alternative to disposing of liquid assets.

The varying rates of growth since 1961 of selected types of financial institutions are shown in the accompanying chart and table. It is apparent that there have been structural shifts in the market shares of banks and other types of institutions. The chartered banks grew more rapidly in 1967 than in 1966 or than

in the period 1961-65. The other institutions (taken as a group) grew less rapidly in 1967 than in the first half of the 1960's although they appear to have expanded about as rapidly as in 1966.

MAJOR CANADIAN ASSETS OF SELECTED FINANCIAL INSTITUTIONS(1)

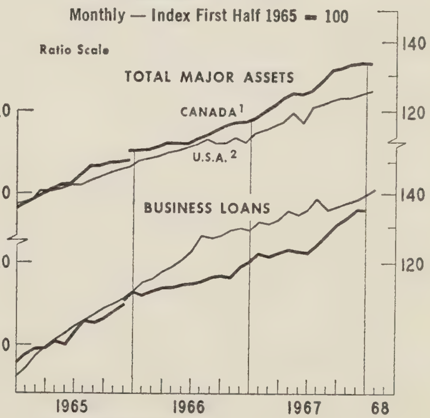
	Millions of dollars Dec. 1967	Percentage increase Average 1962-1965	1966	1967
Non-bank financial institutions(2)				
Quebec savings banks	487	6.3	7.2	8.7
Trust companies	4,180e	21.3	13.1	10.5e
Mortgage loan companies	2,434e	19.7	5.3	7.0e
Sales finance and consumer loan companies	3,985e	15.8	1.4	1.5e
Caisses Populaires Desjardins de Québec	1,479	11.3	12.5	13.6
Sub-total	12,565	17.1	7.1	7.1
Chartered banks(3)	22,893	7.3	6.5	14.2
Total	35,458	10.3	6.7	11.5

e: Estimate.
(1) Excludes fixed assets and investments in subsidiary or affiliated companies.
(2) Includes in some cases relatively small amounts of foreign currency assets.
(3) Foreign currency assets of the banks are included net of their foreign currency liabilities.

In the first nine months of 1967 the total Canadian and net foreign currency assets of the chartered banks increased at a seasonally adjusted annual rate of 16.4 per cent, more than double the 1966 rate of increase. In the final quarter of 1967, however, the growth of the banks' total assets slowed markedly as their holdings of liquid assets declined. Apart from a temporary lull in early summer, the banks' Canadian dollar loans increased at a rapid rate throughout the year.

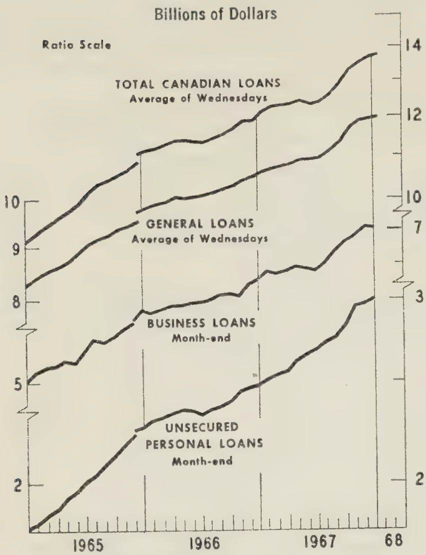
The chartered banks' business loans increased at a seasonally adjusted rate of 3.8 per cent in the first half of 1967 and 20.1 per cent in the second half. The more rapid growth in the second half was partly the result of greater activity by the banks in the field of longer-term business financing.

BANK ASSET COMPARISONS
CANADA - U.S.A.
Monthly — Index First Half 1965 = 100



Seasonally adjusted.
1. Breaks in the series reflect revised treatment of general reserves held against losses on loans and other assets.
2. Commercial banks only.

CHARTED BANK LOANS[1]



Seasonally adjusted.

1. Breaks in the series reflect revised treatment of general reserves held against losses on loans and other assets.

Term loans outstanding under authorizations of $1 million and more accounted for 8.7 per cent of total business loans at the end of 1967 compared with 4.3 per cent a year earlier. This upsurge in term lending by the banks is one of the reasons why bank loans to business rose much more strongly in Canada than they did in the United States in the second half of 1967. Another reason for the relative strength of bank loans to business in Canada may have been the somewhat earlier and stronger resumption of business inventory growth in this country.

As in recent years, the growth in 1967 in outstanding loans under large lines of credit was much more rapid than the growth in loans under smaller authorized lines.

CHARTERED BANK BUSINESS LOANS OUTSTANDING BY SIZE OF AUTHORIZATION

	Millions of dollars Dec. 1967	Percentage increase		
		Average 1962-1965	1966	1967
Under $100,000	1,531	6.3	−4.9	2.4
$100,000 to $999,999	1,812	11.9	0.9	0.4
$1,000,000 to $4,999,999	1,657	17.0	8.8	7.4
Over $5 million	1,919	19.6	33.6	44.5
Total	6,919	12.4	6.9	12.1

Chartered bank activity in the personal loan area was also intensified in 1967. Under stepped-up promotion, unsecured personal loans rose by 21 per cent in 1967 compared with just under 10 per cent in 1966.

Gross residential mortgage loan approvals by the banks during the year (excluding approvals by mortgage company affiliates of banks) amounted to more than $200 million. By year-end the chartered banks' disbursements under conventional mortgage loans approved during 1967 totalled $91 million, and the outstanding amount of National Housing Act mortgages in their portfolios had stabilized, after declining steadily for several years.

The counterpart of the growth in credit extended by banks and other financial institutions in 1967 was a corresponding growth in the public's holdings of deposits and similar claims on institutions. In 1967 the total of currency and all types of chartered bank deposits denominated in Canadian dollars rose by 14.0 per cent compared with 6.7 per cent in 1966. If Government deposits are excluded, the increase was 16.1 per cent compared with 6.5 per cent a year earlier. On the strictest definition of private money holdings—currency plus demand deposits at chartered banks—the increase was 8.0 per cent compared with 7.9 per cent in 1966. In both years the increases in demand deposits were inflated to some extent by the growing practice of banks requiring their deposit and loan customers to maintain stipulated minimum "compensating" balances with them.

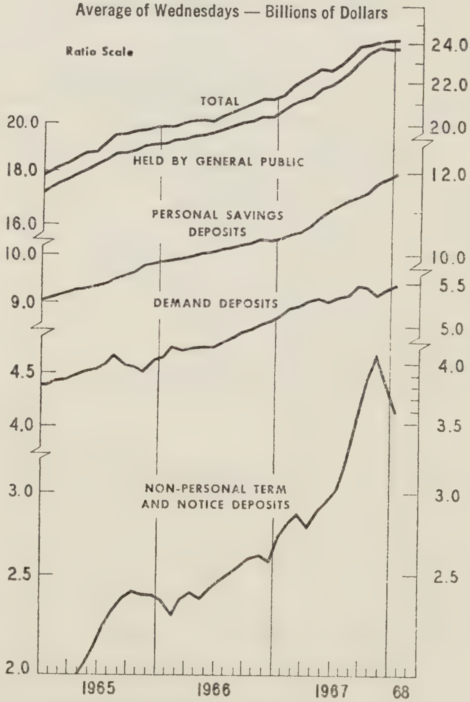
An unusually large growth in currency holdings during 1967 reflected in part the increased cash balances required for travel in connection with Expo and other Centennial activities as well as the demand by collectors for the Centennial currency and coin sets.

Demand deposits were the only category of publicly-held deposits with the chartered banks to grow less rapidly in 1967 than in 1966. Personal savings deposits at the chartered banks rose strongly throughout the year, reflecting the high level of personal saving and the attractiveness of the banks' new non-chequable accounts, which made up about a quarter of personal savings deposits by year-end.

The total of Canadian dollar term and notice deposits and foreign currency "swapped"* deposits at chartered banks rose by about 40 per cent in 1967, with the interest rates offered by the banks on such deposits maintained at very attractive levels compared with rates of return available on alternative outlets

CURRENCY AND CHARTERED BANK CANADIAN DOLLAR DEPOSITS

Average of Wednesdays — Billions of Dollars



Seasonally adjusted.

* Funds converted into a foreign currency, usually U.S. dollars, which have been placed on term deposit with a bank and which the bank has undertaken through a forward contract to convert back into Canadian dollars at maturity.

for short-term funds including market securities. The growth in the banks' non-personal term and notice deposits varied considerably over the course of the year. From August to October the banks competed vigorously for Canadian dollar fixed-term deposits, and both the amount of such deposits and the interest rates paid on them rose to record highs: some banks were reported to have paid rates in excess of 7 per cent for very short-term deposits. In early November the banks became less aggressive in bidding for short-term funds, and their term deposits began to decline. There was, however, a rise in the banks' foreign currency "swapped" deposits during this latter period.

GENERAL PUBLIC HOLDINGS OF CERTAIN FINANCIAL ASSETS[1]

	Millions of dollars Dec. 1967	Percentage Increase	
		1966	1967
Currency	2,739	6.0	10.0
Chartered bank demand deposits	5,566	8.8	7.1
Quebec savings banks' deposits	456	4.7	8.3
Caisses Populaires Desjardins de Québec deposits	1,293	11.7	12.7
Trust and mortgage loan company demand certificates and deposits	1,486e	—.9	1.3e
Sub-total	11,540	6.8	7.6
Chartered banks			
— personal savings deposits	11,630	5.2	14.7
— non-personal term and notice deposits	3,652	7.7	47.3
— foreign currency deposits of residents			
— swapped	894	46.8	12.2
— other	1,091	23.6	30.8
Finance company short-term paper held by residents	661	16.5	5.4
Other commercial paper held by residents	246	11.6	34.4
Provincial and municipal short-term paper	370e	20.0	23.3e
Bankers' acceptances	151	12.8	−10.1
Canada Savings Bonds	6,319	3.8	3.8
Trust company investment certificates	2,779e	20.7	14.8e
Mortgage loan company debentures	1,642e	8.3	10.5e
Total	40,975	8.1	13.0

e: Estimate.
(1) This table includes relatively small amounts of some items held by non-residents.

The above table compares the growth in public holdings of various types of liquid assets. It is clear that assets held primarily as working balances, such as currency and demand deposits, grew much less rapidly in 1967 than did holdings of interest-bearing liquid claims.

While bank deposits rose rapidly in 1967 in the United States as well as in Canada, the increase was relatively larger in this country where structural

changes stemming from the new Bank Act resulted in an unusually large growth of interest-bearing bank deposits. The rate of deposit growth of non-bank intermediaries, on the other hand, was much higher in the United States in 1967 than in 1966; it did not rise significantly in Canada.

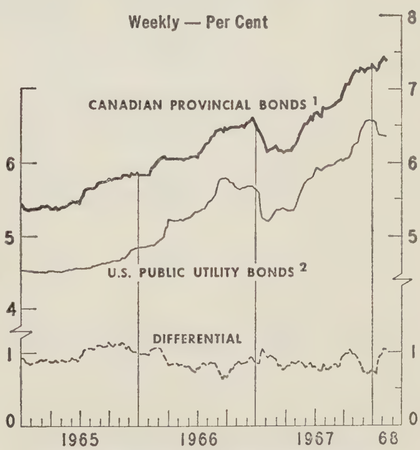
SECURITIES MARKET FINANCING. As shown in Appendix Table IV, net new issues of Canadian-debtor bonds taken up in the domestic market or abroad in 1967 (excluding purchases with government pension plan funds) were roughly 45 per cent greater than in 1966. There was a very large increase in net new issues of market bonds and treasury bills by the Government of Canada. Provincial and municipal governments and their agencies increased their total bond financing substantially as well; and while a large share was purchased with Canada or Quebec Pension Plan funds, the amount of such issues taken up through market channels was considerably higher than in 1966. Corporate bond issues were a little lower than in 1966 and much below the total for 1965.

There was a large increase in the total amount of net new issues denominated in foreign currencies in 1967, particularly issues of provincial and municipal governments. Retirements by the Government of Canada of its foreign-pay bonds outstanding were smaller than in 1966. New foreign-pay issues of corporations declined.

The increase in domestic issues was more than accounted for by the federal government. The banking system added substantially to its holdings of Government of Canada issues, while other financial institutions in Canada absorbed relatively large amounts of corporate, provincial and municipal issues. The amount of common and preferred stock issues by Canadian corporations declined moderately in 1967 and short-term paper outstanding showed a somewhat smaller increase than in 1966.

The proportion of new bond issues sold in the New York market was influenced both by relative borrowing costs and by availability considerations. Yields on long-term issues of prime borrowers rose strongly in both markets from the end of the first quarter onward, with the interest differential little changed from what it was during most of 1966.

BOND YIELD COMPARISONS CANADA - U.S.A.



1. Average yield on the 10 provincial bonds included in the monthly series published by McLeod, Young, Weir and Co. Ltd.
2. Moody's Investor's Service Inc. average yield on public utility bonds.

MORTGAGE MARKET FINANCING. There was a substantial recovery in residential mortgage lending in 1967 from the abnormally low level of the previous year, as may be seen from the table below. NHA mortgage approvals were at a high level in the first half of the year: the usual autumn direct lending programme of Central Mortgage and Housing Corporation was advanced into the spring and in addition approved lenders made an extraordinary volume of NHA loan commitments in March in anticipation of an imminent reduction in the NHA interest rate ceiling. In the second half of the year private mortgage lenders' commitments were almost as large as in the first half of 1967 and much larger than in the second half of 1966. Total mortgage loan approvals were also greater in the second half of 1967 than in the second half of 1966 even though CMHC's direct lending programme for 1967 had been shifted to the first half of the year. The pattern of mortgage lending in 1967 was affected by the entry of the banks into this field on a large scale. Mortgage approvals by traditional mortgage lenders were only slightly higher than in the previous year, while chartered bank approvals rose sharply to reach a total in excess of $200 million during 1967. The supply of mortgage money was also affected in 1967 by the somewhat slower rate of asset growth of life insurance companies and some reduction in the proportion of their assets held in the form of mortgage loans.

MORTGAGE LOAN APPROVALS
(millions of dollars)

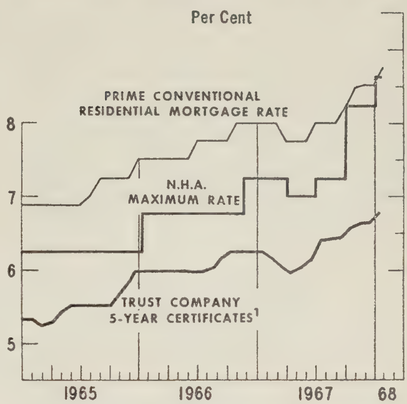
	Private lending institutions						
	Conventional mortgages						
		Residential					
	Non-residential	Existing	New	NHA	Total private	CMHC(1)	Total
1964	507	640	812	353	2,312	376	2,688
1965	581	749	902	320	2,552	483	3,035
1966	382	471	574	191	1,618	561	2,179
1967	379	655	744	356	2,134	669	2,803
1966-First half	218	280	346	132	976	141	1,117
Second half	164	191	228	59	642	420	1,062
1967-First half	187	311	382	219	1,099	452	1,551
Second half	192	344	362	137	1,035	217	1,252

(1) Includes small amounts of loans on existing properties starting in April 1965.

Rates on conventional residential mortgages in January 1968 were about 8¾ per cent compared with about 8 per cent a year earlier. (Changes in 1967 in the method of establishing the maximum rate on NHA mortgages are dis-

cussed on page 35.) In the first months of 1968 most NHA loans were being made at rates in the 8-8½ per cent range, somewhat below the legal maximum of 8⅝ per cent. The increase in mortgage rates since the spring of 1967 has been roughly comparable with the rise in prime corporate bond yields over the same period and with the increase in yields on short-term money market instruments (against which the deposit and certificate obligations of mortgage lenders compete in seeking to attract funds).

MORTGAGE MARKET INTEREST RATES



1. Previous to Dec. 1965, last Wednesday of month; from Dec. 1965, average of Wednesdays.

CONSUMER FINANCE. Total consumer credit outstanding increased in 1967 at about the same 8½ per cent rate as in 1966, significantly below the 14 per cent rate of 1965 and 1964. Consumer credit balances of sales finance companies showed some decline during the year, while unsecured personal loans on the books of chartered banks grew by 21 per cent, double the rate of 1966. Other lenders continued to expand their consumer loans at much the same rate as they had during 1966. In contrast to most other interest rates, those charged on consumer loans seem to have changed but little during 1967.

In the course of the year provincial and federal government legislation came into effect requiring disclosure on a consistent basis of the costs of credit extended to personal borrowers. The provisions of the Bank Act concerning disclosure which came into effect in October 1967 cover all personal loans up to $25,000. As a result of co-operative efforts between sales finance companies and the Investment Dealers' Association, there was also a substantial extension of the information disclosed to investors regarding the operations of these companies.

BUSINESS FINANCE. Business investment in plant and equipment and in additions to inventory declined in 1967. The aggregate internal cash flow of business corporations (retained earnings plus capital cost allowances) remained virtually unchanged, however, so that the net amount of external funds required to finance capital outlays in 1967 apparently declined by several hundred million dollars compared with 1966 requirements. It is rather surprising,

therefore, that the identified amount of new borrowing by non-financial business from institutional and market sources in 1967 shows a considerable increase from the 1966 level. This is illustrated in the table below which does not, however, include borrowing from non-market sources, for example direct investment from abroad. A significant part of the 1967 borrowings shown in the table may have been used to pay down other forms of short-term business debt or to rebuild business holdings of liquid assets (which were depleted in 1966) as a hedge against renewed tightening of credit conditions.

MAJOR SOURCES OF INSTITUTIONAL AND MARKET FINANCING BY NON-FINANCIAL BUSINESS

(millions of dollars)

	1965	1966	1967
Increases in:			
Chartered bank loans in Canadian dollars[1]	849	505	1,087
Chartered bank loans to residents in foreign currencies	258	98	−95
Sales finance company loans	318	−234	15[e]
Other term loans	28	44	37
Non-residential mortgages	382	271	162
Sub-total	1,835	684	1,206
Net new issues of:			
Commercial paper and bankers' acceptances	17	51	27
Bonds	959	793	693
Stocks	336	534	305
Sub-total	1,312	1,378	1,025
Total	3,147	2,062	2,231

e: Estimate.
(1) Total business loans excluding provincially guaranteed loans to utilities plus loans to farmers and grain dealers.

The composition of business borrowing has varied markedly during the past three years. In 1967, as in 1965, the amount of funds raised through bond and stock issues and commercial paper sales was substantially less than the amount of loans obtained from financial institutions, whereas in 1966 credit obtained from such intermediaries was substantially less than securities market borrowing.

Sharp changes in the outstanding amount of chartered bank and finance company loans to business accounted for most of the fluctuation in loans from institutional sources. About 45 per cent of the increase in chartered bank loans

to business in 1967 took the form of term loans under authorized lines of credit of $1 million or more. Business borrowing from sales finance companies which had fallen sharply in 1966 increased again in 1967.

GOVERNMENT FINANCING. The government sector substantially increased its recourse to financial markets in 1967; in contrast to the previous year, the Government of Canada accounted for the largest part of the increase. The sources of government financing are summarized in the following table.

SELECTED SOURCES OF FINANCING: FEDERAL, PROVINCIAL AND MUNICIPAL GOVERNMENTS AND THEIR ENTERPRISES(1)

(millions of dollars)

	1965	1966	1967
Government of Canada			
Increase in securities outside government accounts held by:			
— Bank of Canada	357	1	334
— chartered banks	19	167	740
— general public	−215	−29	−142
Sub-total	161	139	932
Increase (−) in government cash balances	−147	−49	298
Total Government of Canada financing	14	90	1,230
Provincial and municipal governments			
Increase in loans from:			
— chartered banks	230	139	124
— CMHC and MDLF	126	181	164
Increase in short-term paper outstanding	90e	50e	70e
Increase in outstanding bonds:			
— purchased out of Canada and Quebec Pension Plan funds	-	601	825e
— foreign currency issues	267	423	821
— other	733	808	747
Sub-total	1,000	1,832	2,393
Total provincial-municipal financing(2)	1,446	2,202	2,751

e: Estimate.

(1) To obtain a consolidated total of federal plus provincial-municipal financing, loans from Central Mortgage and Housing Corporation and the Municipal Development and Loan Fund to the provinces and municipalities would have to be eliminated, as well as changes in provincial-municipal holdings of Government of Canada securities including Government of Canada securities purchased with Canada and Quebec Pension Plan funds, in order to avoid double-counting.

(2) To the extent that provincial government accounts purchase provincial or municipal securities the total of provincial-municipal financing is overstated.

The Bank of Canada and the chartered banks made net purchases of Government of Canada securities of $334 million and $740 million respectively in 1967 while the general public reduced their holdings by $142 million despite net purchases of $229 million of Canada Savings Bonds. The remainder of the Government of Canada's requirements was met by a reduction in cash balances of $298 million. The increased requirements of the provinces and municipalities and their enterprises were met largely by the higher receipts available from the Canada and Quebec Pension Plans and by a larger volume of security issues in the United States. Net new issues of municipal securities increased by $116 million in 1967 but this was more than offset by declines in municipal borrowing from the banks and from the Municipal Development and Loan Fund. With some provinces assuming increased responsibility for the financing of municipal activities, higher municipal requirements were reflected in larger provincial borrowing.

During the year governments at all levels experienced increasing difficulty in financing their expanded activities by sales of bonds to the Canadian public. Provinces and municipalities turned heavily to the United States capital market for additional funds. The tax increases proposed in the Government of Canada's November budget, and the restraint on the growth of Government expenditures, were designed in part to ease the strains on the capital market.

The increase in the over-all financial requirements of the Government of Canada in 1967 (see Appendix Table III) resulted from a greater rise in expenditures than in revenues, and from a further increase in the Government's major loans and advances; the increase in the latter was less than in 1966, mainly because of reductions in the amount of new funds needed for the Municipal Development and Loan Fund and for Expo. There was a larger net use of funds in connection with the Government's foreign currency transactions which moved from being a net source of Canadian dollars in the amount of $583 million in 1966, when the Government was selling foreign currency assets, to being a net user of funds in the amount of $95 million in 1967, when holdings of such assets increased.

The net revenue-expenditure position of provincial and municipal governments as a group improved somewhat in 1967; the increased demand for funds by these governments was due to the rising capital investment programmes of their Crown enterprises and to greater provincial lending to the private sector for industrial development, farm credit and residential construction.

PUBLIC DEBT MANAGEMENT OPERATIONS. The Government of Canada made seven offerings of new marketable bonds during 1967, the last of which was delivered in January 1968. The total of marketable direct and guaranteed bonds delivered in 1967 amounted to $1,935 million while outstanding issues of $1,614 million matured or were cancelled, leaving a net increase in outstanding market bonds of $321 million. Canada Savings Bonds outstanding at the end of 1967 were $229 million higher than a year earlier while the sale of treasury bills during the year increased the amount of these securities outstanding by $285 million. There was a special issue of 303-day bills on February 1 for $100 million and a 364-day issue on December 1 for $125 million to refund the former issue and provide $25 million of new money. Starting in March 1967 small amounts were also added at weekly tenders from time to time to the total of outstanding 91-day bills.

The table on page 62 summarizes the new issues and refundings of bonds during the year and also shows the yield and term to maturity of each new issue. On balance the term to maturity of bond issues tended to shorten during the year and the average yield increased.

Faced with high and rising interest rates over most of the year, Government borrowing operations were planned to raise funds without placing undue upward pressure on the long end of the market. The practice of providing a certain amount of leeway in the amount of new offerings, which was started in the December 15, 1966 issue, was continued in 1967. All issues but those on August 1 (and $125 million of the April 1 issue) were offered in amounts that could be varied by 10 per cent above or below the amount initially announced. The October and December issues offered an exchange option; holders of these relatively short-term securities are allowed to exchange them at par for bonds of 26-year and 27-year terms respectively at any time up to one year before their original maturity. On one occasion when new issues were announced, the Bank of Canada stood ready to purchase bonds of the newly issued short-term tranches in exchange for existing longer-term issues held in its portfolio on terms which were announced at the time of the offering; this widened the choice of issues available to investors in the offering.

The 1967 series of Canada Savings Bonds offered the same interest yield to maturity as the 1966 series but increased the initial coupons from 5 to 5¼ per cent. Corporations and other businesses, churches, charities and other associations were made eligible to purchase Canada Savings Bonds for the first time and the maximum amount permitted for each purchaser was increased to $50,000.

SUMMARY OF DIRECT NEW ISSUES AND REFUNDINGS GOVERNMENT OF CANADA MARKET BONDS

Date	Issues offered	Amount delivered (millions of dollars par value)	Years to maturity	Yield to maturity	Amount refunded (millions of dollars par value)
1967					
Feb. 1	5½% Oct. 1, '75	70	8 yrs. 8 mos.	5.70	
	5½% Aug. 1, '80	30	13 yrs. 6 mos.	5.71	
	5¾% Sept. 1, '92	50	25 yrs. 7 mos.	5.69	
		150			–
Apr. 1	4½% Apr. 1, '68	175	1 yr.	4.66	
	5% Oct. 1, '73	200	6 yrs. 6 mos.	5.21	
	5¼% May 1, '90	125	23 yrs. 1 mo.	5.48	
		500			325
June 1	4½% June 15, '68	160	1 yr. ½ mo.	4.60	
	5% July 1, '70	100	3 yrs. 1 mo.	5.09	
	5½% Dec. 1, '74	100	7 yrs. 6 mos.	5.67	
		360			325
Aug. 1	5% Oct. 1, '68	20	1 yr. 2 mos.	5.44	
	5½% Apr. 1, '69	70	1 yr. 8 mos.	5.56	
	6% Dec. 15, '71	85	4 yrs. 4½ mos.	6.06	
		175			–
Oct. 1	4¾% Dec. 15, '68	125	1 yr. 2½ mos.	5.61	
	5½% Dec. 15, '69	175	2 yrs. 2½ mos.	5.86	
	6% Apr. 1, '71(1)	225	3 yrs. 6 mos.	6.00	
		525			525
Dec. 1	6¼% Dec. 1, '73(2)	225	6 yrs.	6.35	105
1968					
Jan. 15	6% Feb. 15, '70	250	2 yrs. 1 mo.	6.20	
	6% Dec. 15, '71	200	3 yrs. 11 mos.	6.44	
		450			400

(1) Exchangeable on or before Apr. 1, 1970 into equal par value 6% bonds due Oct. 1, 1993.
(2) Exchangeable on or before Dec. 1, 1972 into equal par value 6¼% bonds due Dec. 1, 1994.

FINANCIAL TRANSACTIONS OF CANADIANS WITH NON-RESIDENTS. The net use of non-resident savings by Canadians declined from $1,137 million in 1966 to $425 million in 1967. Ordinary capital transactions in 1967 produced an inflow of $506 million while special purchases of U.S.-pay bonds by the Government of Canada amounted to the equivalent of $63 million. Official reserves rose by $18 million. In 1966 ordinary capital transactions had produced an inflow of $960 million, special purchases of U.S.-pay bonds amounted to $182 million and official reserves declined by $359 million. Details of the main transactions in the capital account are given in the table on page 64.

Foreign direct investment in Canada amounted to $540 million in 1967 compared with $710 million in the previous year. Deliveries of new issues of Canadian bonds sold to non-residents in 1967 amounted to $1,274 million, $135 million less than in 1966. New offerings rose in the first quarter of 1967 from the fairly low levels prevailing in the second half of 1966. In the second quarter offerings were boosted by some large issues offered for deferred delivery. Following a mid-summer lull, activity in the new issue market picked up in September and remained high until late in the year. Owing to differences of timing, deliveries were considerably less than offerings in 1967, and the total of undelivered new issues was much higher at year-end than it had been twelve months earlier.

NEW ISSUES OF CANADIAN BONDS SOLD TO UNITED STATES RESIDENTS

(millions of Canadian dollars)

	By date of offering	By date of delivery	Undelivered at end of period
1966			
1 Q	351	512	157
2 Q	386	350	193
3 Q	215	301	107
4 Q	210	195	122
1967			
1 Q	357	312	167
2 Q	487	282	372
3 Q	330	257	445
4 Q	286	367	364

Transactions in outstanding securities gave rise to less capital outflow in 1967 than in 1966. The pattern of trade in outstanding Canadian stocks, which had resulted in substantial capital outflows since 1962, was reversed at mid-year

CANADIAN BALANCE OF INTERNATIONAL PAYMENTS

(millions of Canadian dollars)

	1966	1967	1967 1 Q	1967 2 Q	1967 3 Q	1967 4 Q
Current Account Balance	−1,137	−425	−316	−248	224	− 85
Capital Account Transactions						
Direct investment						
foreign investment in Canada[1]	710	540	125	145	140	130
Canadian investment abroad[1]	− 20	− 50	− 30	− 10	− 20	10
Canadian stocks						
net transactions	− 88	53	− 43	− 10	35	71
Canadian bonds						
new issues	1,409	1,274	323	291	266	394
special repurchases of Govt. securities	− 157	− 43	–	− 34	–	− 9
other retirements	− 340	−313	− 57	−104	− 61	− 91
net trade in outstandings	− 103	− 56	− 10	− 23	− 9	− 14
Foreign securities						
Government purchases of IBRD bonds	− 25	− 20	–	–	–	− 20
other transactions	− 398	−328	− 56	− 52	−124	− 96
Columbia River Treaty						
net transactions	32	44	–	–	–	44
Export credits						
net transactions	− 47	107	17	50	19	21
Foreign currency flows through the Canadian banks	− 467	−400	252	− 59	−232	−361
Canadian finance company paper	− 4	− 49	7	− 24	− 55	23
Canadian finance companies' other short-term obligations	154	34	− 17	11	− 31	71
Other long and short-term capital	122	−350	−208	12	− 96	− 58
Total capital account transactions	778	443	303	193	−168	115
Changes in reserves and IMF position						
Official holdings of gold and foreign exchange	− 462	34	− 35	− 37	54	52
Net position with IMF	103	− 16	22	− 18	2	− 22
Total	− 359	18	− 13	− 55	56	30

(1) Exclusive of undistributed earnings.

Note: A positive figure indicates an inflow of capital into Canada, and thus an increase in Canadian liabilities or a decrease in Canadian assets. A negative figure indicates the reverse.

and produced an appreciable inflow in the second half of the year. Outflows from trade in outstanding Canadian bonds and from trade in foreign securities which had become large in 1966 were both smaller in 1967. Offerings of new issues of securities in Canada by foreign borrowers continued to be officially discouraged, as were purchases by Canadian investors of "off-shore" securities of United States corporations, that is, the securities of United States corporations or their non-Canadian subsidiaries which would be subject to the United States Interest Equalization Tax if purchased by United States residents.

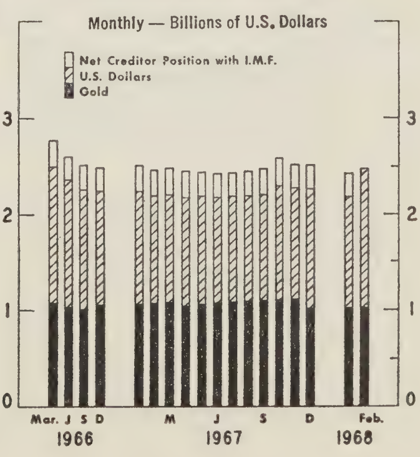
In 1967 export credits produced net repayments to Canada following substantial outflows in the preceding five years. Repayments under existing export credit contracts, some in advance of maturity, grew rapidly and exceeded the reduced rate of new extensions by $107 million.

The outflow from short-term capital transactions was appreciably larger in 1967 than in 1966. There was a continued reduction in non-resident holdings of Canadian finance company paper, a smaller increase in foreign holdings of other short-term obligations of finance companies, and a substantial swing in short-term capital flows through commercial trade credit. During most of 1967 there was less interest-rate incentive on a covered basis for United States investors to buy Canadian short-term paper than in 1966.

Capital outflows through banking transactions in foreign currencies fell from $467 million in 1966 to $400 million in 1967. In 1967 there were substantial flows to the United States and Britain. Some of these funds came from other overseas countries and the remainder came from the banks' transactions with Canadian residents.

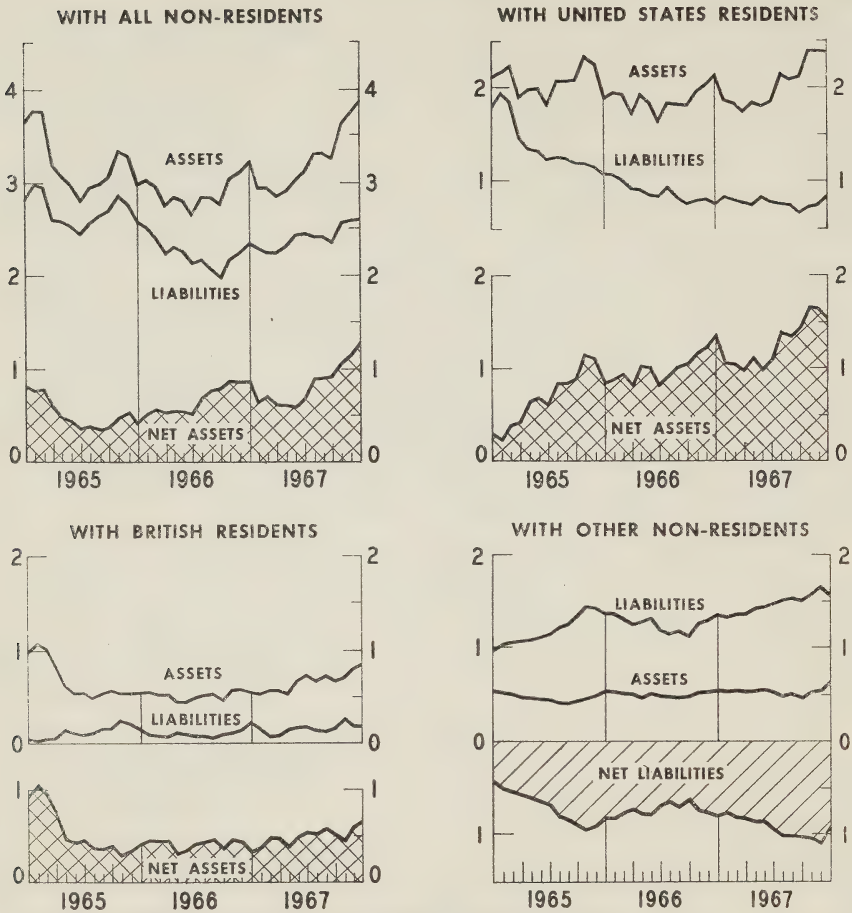
In 1967 Canada continued to work to a target level of U.S. $2,550 million for its foreign exchange reserves, including for this purpose its net creditor position with the International Monetary Fund; the target had been reduced in 1966 from the figure of U.S. $2,700 million set in 1963. This reserve arrangement was part of an agreement with the United States Administration which provided that new issues of long-term securities by Canadians in the United States market should be exempt from the Interest Equalization Tax and from the United States guidelines affecting non-bank financial institutions.

OFFICIAL HOLDINGS OF GOLD AND U.S. DOLLARS AND NET CREDITOR POSITION WITH THE I.M.F.



CHARTERED BANK FOREIGN CURRENCY ASSETS AND LIABILITIES WITH NON-RESIDENTS[1]

Monthly — Billions of Canadian Dollars



1. Assets and liabilities carried on the books of head offices and branches in Canada.

With a view to keeping Canada's reserves near the agreed target the Government of Canada in 1967 repatriated U.S. $40 million of its own U.S.-pay securities and purchased U.S. $19 million of bonds of the International Bank for Reconstruction and Development from United States residents; for the same reason the Government had repatriated U.S. $145 million of its own securities and purchased U.S. $23 million of IBRD bonds in 1966. At the end of 1967, Canada's reserves were U.S. $2,516 million compared with U.S. $2,499 million a year earlier; official holdings of gold and U.S. dollars rose by U.S. $32 million

from U.S. $2,236 million to U.S. $2,268 million while Canada's net creditor position with the IMF declined by U.S. $15 million.

The spot rate for the United States dollar in the Canadian foreign exchange market, which had reached a low point of 1.07¾ in January 1967, moved slightly above the parity rate of 1.08108 in February and stayed close to that level until late May. It declined thereafter and reached its lower limit* of 1.07¼ in the latter part of October. The rate then rose sharply in January 1968 and was at or close to 1.08¾ throughout February. The forward exchange rate for the U.S. dollar in Canada was at a small premium in January and February 1967 and a small discount in March and early April. It rose to a substantial premium in October, declined in late November and rose again in the early part of 1968.

In 1967 the Bank of Canada continued to participate in various group arrangements for short-term credit between central banks.

One arrangement entered into in 1966 operates through the Bank for International Settlements and provides for temporary assistance to the Bank of England against the impact on Britain's gold and dollar reserves of declines in the sterling balances held by non-residents. The Bank of Canada's share remains at U.S. $60 million as may be needed. A second arrangement entered into in 1966 by a number of central banks to provide temporary assistance to the Bank of England expired in April 1967 and a similar arrangement was made in November under which the Bank of Canada's share is U.S. $100 million, as may be required. In addition, as agent for the Exchange Fund Account, the Bank of Canada participated in November 1967 in another group arrangement to provide U.S. $15 million as the Canadian share of a short-term credit by the Bank for International Settlements to assist Britain to discharge its outstanding repurchase commitment of the equivalent of U.S. $250 million on its 1964 drawing from the IMF.

In 1967 our reciprocal facilities with the Federal Reserve System were increased from U.S. $500 million to U.S. $750 million. This arrangement is part of the network of reciprocal short-term facilities created in 1962 between the Federal Reserve System and a number of central banks. Under the arrangement the Bank of Canada drew U.S. $250 million from the Federal Reserve System in January 1968.

On February 26, 1968 the Government of Canada announced that it had taken steps to draw U.S. $426 million from the IMF and to place these amounts in official reserves. This drawing consisted of Canada's creditor position in the IMF of U.S. $241 million and the equivalent of Canada's gold contribution to the IMF of U.S. $185 million.

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* The par value of the Canadian dollar is U.S. $0.925, which is equivalent to U.S. $1 = Cdn. $1.08108. In accordance with Canada's undertaking as a member of the IMF to ensure that the exchange rates on transactions in Canada do not differ from this parity by more than 1 per cent on either side, the limits for the U.S. dollar in the Canadian inter-bank foreign exchange market are 1.07¼-1.09.

APPENDIX TABLE 1

BANK OF CANADA NET TRANSACTIONS IN GOVERNMENT OF CANADA SECURITIES IN 1967

(delivered basis – par value in millions of dollars)

	Net purchases from (+) or net sales to (−) investment dealers and banks						
		Bonds[1]					
	Treasury bills	3 and under	3 to 5	5 to 10	Over 10	Sub-total bills and bonds	Securities under PRA
Jan.	−3	+3	–	–	–	–	–
Feb.	–	+8	–	–	+1	+9	+12
Mar.	−9	+5	–	–	–	−4	−12
Apr.	+51	–	–	+9	+14	+74	+5
May	+2	–	–	+3	+34	+40	+7
June	+21	−1	+4	+7	+52	+82	−12
July	–	–	–	–	–	–	+8
Aug.	+4	–	−4	–	+7	+7	−8
Sept.	+53	–	–	–	+1	+55	–
Oct.	−30	–	–	+11	+2	−17	–
Nov.	−13	–	–	–	+5	−8	–
Dec.	−18	–	–	+13	–	−4	–
Total	+58	+16	–	+42	+117	+233	–

(1) Classified by years to maturity at time of transaction.

Net transactions with Government and other client accounts								
Purchases (+) of new issues less matured holdings		Net purchases from (+) or net sales to (−)				Net change in holdings of Government of Canada securities		
		Securities Investment Acct.		Other Government and client accounts				
bills	bonds	bills	bonds	bills	bonds	bills	bonds	total
− 44	− 19	–	–	− 26	−12	− 74	− 28	−101
+ 37	+ 52	–	–	− 23	− 3	+ 20	+ 64	+ 84
+ 81	–	–	–	− 25	− 2	+ 40	− 3	+ 38
+ 4	+ 48	–	–	− 29	−11	+ 30	+ 60	+ 90
+ 29	–	–	–	–	–	+ 29	+ 47	+ 75
+ 29	+ 33	–	− 32	− 39	− 1	+ 8	+ 52	+ 60
+ 7	–	–	–	− 19	− 3	− 6	–	− 6
− 12	+ 50	–	–	− 15	− 4	− 29	+ 47	+ 18
+ 99	–	–	–	− 9	− 2	+143	− 1	+143
+ 30	+ 8	–	− 11	− 15	−10	− 15	+ 1	− 14
− 50	–	–	–	− 18	− 4	− 81	+ 1	− 80
+153	+ 76	–	−125	− 69	− 3	+ 66	− 39	+ 27
+362	+249	–	−168	−288	−54	+132	+202	+334

APPENDIX TABLE II

BANK OF CANADA ASSETS AND LIABILITIES

(monthly changes – millions of dollars)

	Government of Canada securities at book value	Net foreign currency assets	Investment in IDB	All other assets, net	Note circulation	Canadian dollar deposit liabilities		
						Chartered banks	Government of Canada	Other
1967								
Jan.......	−100	− 80	+ 3	+ 9	−158	+ 14	− 33	+9
Feb.......	+ 84	− 54	+ 2	−10	+ 13	− 56	+ 71	−6
Mar.......	+ 39	− 22	+ 2	+ 8	+ 15	+ 79	− 65	−3
Apr.......	+ 88	+ 27	+ 9	+62	+ 52	+ 27	+107	+1
May......	+ 73	+ 27.	+ 2	− 2	+ 68	+ 1	+ 28	+5
June......	+ 57	− 54	+ 2	−56	+ 63	− 3	−114	+3
July......	− 6	+ 76	+ 1	+ 3	+ 62	− 10	+ 26	−4
Aug.......	+ 19	− 56	+ 1	−31	− 11	− 48	− 5	−3
Sept......	+142	− 23	+ 1	−11	–	+ 24	+ 83	+2
Oct.......	− 14	+ 20	+ 7	−40	+ 10	− 40	+ 2	+1
Nov.......	− 79	+ 17	+ 2	− 6	+ 1	−102	+ 33	+2
Dec.......	+ 25	–	+ 2	+46	+131	+ 64	−124	+2
Year....	+329	−123	+33	−27	+245	− 49	+ 8	+8

GOVERNMENT OF CANADA FINANCIAL ACCOUNTS

(millions of dollars)

	Calendar 1965	Calendar 1966	Calendar 1967
Budgetary balance	70	−461	−645
Adjustments to National Accounts basis:			
Government employer-employee pension contributions (excluding CPP) and interest earnings, less pension payments	342	402	440e
Unemployment insurance and old age security receipts, less disbursements	240	280	104e
All other adjustments	− 84	− 97	−219e
1. National Accounts balance	568	124	−320e
Net outlays on financial assets:			
Increase in major loans and advances:			
Central Mortgage and Housing Corporation	276	456	678
Farm Credit Corporation	145	167	168
Export Credits Insurance Corporation	41	38	28
Municipal Development and Loan Fund	85	122	66
Veterans Land Administration	21	51	61
1967 World Exhibition	22	115	68
Other	67	113	198
Sub-total	657	1,062	1,267
Canada Pension Plan receipts less acquisitions of provincial securities	–	− 69	8
Refundable corporation tax	–	−134	−106
Corporation tax accruals less collections	− 92	− 88	−210
Foreign currency items (other than debt redemption):			
Advances to the Exchange Fund(1)	18	−696	86
Subscriptions to international agencies	22	226	19
Change in demand notes payable to international agencies	119	−106	2
IBRD and Columbia River securities	− 32	− 7	− 12
Sub-total of foreign currency items	127	−583	95
All other assets and liabilities	−110	26	−144
2. Total outlays on financial assets	582	214	910
Increase in Government of Canada securities outside government accounts (including U.S. dollar pay issues)	161	139	932
Deduct — Increase in government cash balances	147	49	−298
3. Financing (Total 3 = Total 2 − Total 1)(2)	14	90	1,230

e: Estimate.

(1) Excludes advances made to the Exchange Fund to finance the remission of net Fund earnings to the Government of Canada.

(2) As on Bank of Canada books. Accounting differences between these and the Public Accounts are reflected in the item "All other assets and liabilities".

APPENDIX TABLE IV

NET NEW SECURITIES ISSUES OF CANADIAN BORROWERS, 1965-1967

(par value in millions of Canadian dollars)

	Canadian dollars		
	1965	1966	1967
Government of Canada direct & guaranteed market securities outside government accounts	−88	79	746
Canada Savings Bonds	253	223	229
Provincial and municipal bonds, excluding those purchased with Canada and Quebec Pension Plan funds[e]	733	808	747
Corporate and other bonds	986	532	658
Sub-total	1,884	1,642	2,380
Short-term paper and bankers' acceptances(2)	−74	210	62
Corporate stocks	464	577	427
Total, excluding purchases of provincial and municipal bonds with the Canada and Quebec Pension Plan funds[e](3)	2,274	2,429	2,869
Provincial and municipal bonds purchased with Canada and Quebec Pension Plan funds, not included above[e](3)	–	601	825

e: Estimate.

(1) Converted to Canadian dollars at market rates.

(2) Includes short term paper issued by provinces, municipalities and their agencies.

(3) There is a modest degree of double-counting in the total arising out of purchases of other than provincial and municipal bonds with Canada and Quebec Pension Plan funds.

Foreign currencies[1]			Total		
1965	1966	1967	1965	1966	1967
−5	−163	−44	−93	−84	702
–	–	–	253	223	229
267	423	821	1,000	1,231	1,568
332	441	205	1,318	973	863
594	701	982	2,478	2,343	3,362
−36	−24	19	−110	186	81
9	7	2	473	585	429
567	684	1,003	2,841	3,114	3,872
–	–	–	–	601	825

BANK OF CANADA STATEMENT OF INCOME AND EXPENSES

(thousands of dollars)

	1967	1966
Income		
On investments (including deposits)	$193,240	$164,308
All other income	204	182
Total income	$193,444	$164,490
Operating Expenses		
Salaries(1)	$ 5,658	$ 4,889
Contributions to pension and insurance funds	501	549
Other staff expenses(2)	349	266
Directors' fees	28	20
Auditors' fees and expenses	83	83
Taxes (municipal and business)	1,248	1,116
RCMP guards and electric protection	175	153
Insurance	60	51
Bank notes — production and shipment	5,591	4,273
Data processing and computer costs	257	129
Other equipment and premises (net)	371	387
Printing of publications	117	100
Other printing and stationery	219	213
Postage and express	241	235
Telephones and telegrams	189	180
Travel and transfer expense	184	150
Interest paid on unclaimed balances	59	57
All other expenses	242	155
Total operating expenses	$ 15,572	$ 13,006
Depreciation on Buildings and Equipment	848	899
Net Income Paid to Receiver General of Canada	177,024	150,585
	$193,444	$164,490

(1) The number of staff averaged 1,002 in 1967 and 963 in 1966.
(2) Includes overtime pay, medical services and cafeteria expense.

ASSETS

	1967	1966
Deposits payable in foreign currencies		
Pounds sterling and U.S.A. dollars	$ 90,641,089	$ 54,906,483
Other currencies	251,509	243,844
	90,892,598	55,150,327
Cheques on other banks	105,583,628	153,208,125
Advances to chartered and savings banks	3,000,000	–
Accrued interest on investments	46,473,690	43,222,855
Investments — at amortized values		
Treasury bills of Canada	538,304,355	409,110,486
Other securities issued or guaranteed by Canada maturing within three years	1,269,681,384	1,142,933,993
Other securities issued or guaranteed by Canada not maturing within three years	1,940,122,952	1,867,247,287
Debentures issued by Industrial Development Bank — Note	270,231,238	239,776,843
Securities issued by the United Kingdom and the United States of America	10,710,303	171,738,732
	4,029,050,232	3,830,807,341
Industrial Development Bank		
Total issued share capital at cost — Note	45,000,000	42,000,000
Bank premises		
Land, buildings and equipment Cost less accumulated depreciation	17,348,143	16,541,828
Net balance of Government of Canada collections and payments in process of settlement	72,995,671	64,663,751
Other assets	1,280,080	1,201,760
	$4,411,624,042	$4,206,795,987

Note: The audited financial statements of the Industrial Development Bank as at September 30, 1967 were issued to the public on December 6, 1967.

L. RASMINSKY, Governor
Ottawa, January 31, 1968

A. J. NORTON, Chief Accountant

AS AT DECEMBER 31, 1967
(with comparative figures as at December 31, 1966)

LIABILITIES

	1967	1966
Capital paid up	$ 5,000,000	$ 5,000,000
Rest fund	25,000,000	25,000,000
Notes in circulation	2,978,939,617	2,733,633,656
Deposits		
Government of Canada	42,171,527	34,060,265
Chartered banks	1,062,017,745	1,111,257,971
Other	37,925,605	29,727,708
	1,142,114,877	1,175,045,944
Liabilities payable in foreign currencies		
To Government of Canada	32,367,592	31,464,061
To others	2,450,753	5,460,415
	34,818,345	36,924,476
Bank of Canada cheques outstanding	224,406,917	229,491,229
Other liabilities	1,344,286	1,700,682
	$4,411,624,042	$4,206,795,987

Auditors' Report • We have examined the statement of assets and liabilities of the Bank of Canada as at December 31, 1967. Our examination included a general review of the accounting procedures and such tests of accounting records and other supporting evidence as we considered necessary in the circumstances. In our opinion, the accompanying statement of assets and liabilities presents fairly the financial position of the Bank as at December 31, 1967.

JACQUES RENÉ DE COTRET, C.A.
of René de Cotret & Cie.

T. A. M. HUTCHISON, F.C.A.
of Peat, Marwick, Mitchell & Co.

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BANK OF CANADA

ANNUAL REPORT OF THE GOVERNOR TO THE MINISTER OF FINANCE

AND STATEMENT OF ACCOUNTS

FOR THE YEAR 1968

BANK OF CANADA *Ottawa 4*

February 28th, 1969.

The Hon. E. J. Benson, P. C.,
Minister of Finance,
Ottawa, Ontario.

Dear Sir,

In accordance with the provisions of the Bank of Canada Act I am transmitting herewith my report for the year 1968 and a statement of the Bank's accounts for this period which is signed and certified in the manner prescribed in the by-laws of the Bank.

Yours very truly,

L. Rasminsky

Governor

BANK OF CANADA

Report of the Governor — 1968

Some Highlights of the Year

The performance of the Canadian economy last year was satisfactory in many ways, but it was marred by continuing inflation. The period of subdued growth which had lasted from the spring of 1966 to the final months of 1967 gave way to sharply accelerated economic expansion in 1968, led by an abnormally strong demand for Canadian exports. Real output appears to have risen by some 6 per cent in the course of the year, a rate which approached the average of the years of rapid expansion from 1961 to 1966. Employment also grew strongly, and the upward drift in the national unemployment rate which had carried it from a 3½ per cent average in 1966 to nearly 5½ per cent in the summer of 1968 was checked; unemployment declined in the latter part of the year and in January 1969. This occurred notwithstanding a large increase in the labour force and a welcome increase in average output per worker. Although imports grew rapidly in 1968, the increase in exports was substantially greater, especially to the United States where demand pressures were strong, and our deficit on current account was less than it had been for many years.

In 1967 there had been some hopeful signs that price inflation was gradually being brought under control. In 1968, however, little further progress seems to have been made. Indeed, between the fourth quarter of 1967 and the fourth quarter of 1968 the price index of all goods and services, as measured in the Gross National Product, rose by 4 per cent, somewhat more than in 1967. The Consumer Price Index has also continued to rise at the rate of about 4 per cent a year, with no clear evidence of any tendency to slow down.

The stubbornness of the inflation problem in the face of levels of unemployment which have ranged between about 4½ and 5½ per cent during the past year or more is very disappointing. It seems clear that the attitudes of all groups in the community to price and income increases within their influence are affected not only by the levels of unemployment and idle plant capacity but also by expectations about future price trends and by the degree of buoyancy in business conditions and in employment opportunities. It should be pointed out, moreover, that although unemployment rose substantially in the Atlantic Provinces and Quebec in 1968, it was not significantly higher in the rest of the country at the end of the year than it had been at the end of 1967.

A major factor that made it more difficult for Canada to achieve good price performance in 1968 than in the immediately preceding years was the marked intensification of demand pressures from beyond our borders, particularly from the United States. By the end of the year, unemployment in that country had fallen to the lowest level in fifteen years; the rate of price increase in 1968 was the highest since the Korean War. In the course of the year the U.S. consumer price index rose by 4.7 per cent compared to a rise of 4.1 per cent in Canada. This meant that international competition imposed less restraint on price increases in Canada than had been the case in earlier years. There are, however, some signs that we may be moving towards an improved situation insofar as external influences on our prices are concerned. In the United States a 10 per cent surcharge on personal and corporate income tax became effective at mid-year and was accompanied by cuts in planned Government expenditure. The full effect of these measures has not yet been felt, although by the fourth quarter there was a noticeable slowing down of the growth of consumer expenditures. Monetary conditions in the United States, which had eased during the summer, tightened in the latter part of the year and have remained tight in the first months of 1969. While no one can be certain how effective these measures will be, it is encouraging that United States economic policy now appears to be clearly aimed at reducing demand pressures.

It is difficult to form a precise judgment as to the extent to which Canada's current inflationary problem originates outside the country and the extent to which it is due to domestic causes. However, one can hardly avoid the conclusion that even though unemployment averaged about 5 per cent last year the total volume of spending in Canada was at too high a level to be compatible with price performance which, in the prevailing circumstances, would have been acceptable. This conclusion is not a welcome one: we all naturally wish to bring inflation under control with a minimum of unused resources and unemployment in the economy. It is for this reason that I have advocated on earlier occasions that it would be desirable for the Government to make a systematic effort to bring the influence of informed public opinion to bear on decisions regarding increases in prices and incomes.

I welcome the start that has been made in this direction by the Government's decision to try to reinforce the traditional policies of economic stabilization by establishing a Price and Incomes Commission. This decision has introduced a new and potentially constructive factor into the situation. For the first time there will be an official body charged with the responsibility of continuous analysis of price and cost developments, of making policy recommendations, and of educating opinion as to what actions and policies are consistent or inconsistent with reasonable price stability. It is encouraging to know that this Commission will soon be set up and begin to function.

As regards the traditional methods of economic stabilization, that is, fiscal and monetary policies, their stance is now such as to moderate demand pressures. The monetary policy which is being followed is one of restraint; its development over the past year is described in the next section. The Government's budgetary deficit and its cash requirements in 1968 turned out to be much larger than had been planned, but the October budget provided for a balance in the fiscal year ending March 31, 1970 and for a considerable reduction in the Government's cash requirements. What is required now to deal with the problem of inflation is not, therefore, a drastically different setting of policy but rather the determination to persist with the present one—and if necessary to reinforce it from time to time—for as long as this is needed to reduce the domestic pressures that have contributed to the recent rates of price and cost increase.

This determined approach to policy is essential because inflationary expectations have now become very strong. The persistence of rising prices has resulted in a growing tendency on the part of many sections of the public to think of inflation as a normal characteristic of our society. This has developed to the point where firm evidence of progress in checking inflation will be required to break its hold on the economy.

The development of an inflation psychology has had an increasingly serious impact on the availability and cost of long-term debt financing and on the functioning of capital markets in North America. The basic reason why interest rates have risen so high and bond prices fallen so low is the belief of investors and borrowers that the value of money will continue to decline significantly. This belief has made investors increasingly reluctant to commit their funds to long-term bond issues even at progressively higher interest rate levels, and it has made borrowers increasingly resigned to paying these higher rates rather than postpone their spending plans. The shrinkage in the flow of funds into the long-term bond market has been accompanied by an increased flow into liquid, short-term deposits at banks and other institutions and by an intensification of the demand for common stocks and real estate as a hedge against inflation. A growing proportion of the issues of borrowers who have to rely on bond financing to cover their requirements—such as the federal, provincial and municipal governments—has had to be absorbed by the banking system or sold in capital markets outside Canada. Even so, the cost and difficulty of bond financing in Canada has continued to increase. A fundamental reversal of these trends in capital markets will depend on decisive progress being made towards price stability in North America.

It is of crucial importance to all Canadians that the problem of inflation be dealt with successfully, that we bring to an end the excessive price and cost increases which are threatening to undermine our prospects for durable growth in the future. Fortunately, in addition to the possibility of less pressure on price

levels from external sources, there is evidence that some developments in the domestic economy are working with us. There was an encouraging improvement in productivity in 1968, though it has to be acknowledged that this was to a large extent a cyclical phenomenon resulting from the rapid increase in production which followed the earlier slow-down from mid-1966 to late 1967. Wage settlements were being negotiated at a somewhat more moderate rate of increase in the closing months of 1968, though at increases that were still substantially above even the enhanced growth in productivity. Broadly speaking, our main public policies seem to be pointed in the right direction—but we shall need a consistency of approach and a deep determination to persevere until we are certain that we have dealt effectively with the problem. The stakes are too great to warrant anything less.

MONETARY POLICY. A detailed chronological account of the Bank's monetary operations is given in the later section of this Report dealing with financial developments. Policy went through three phases which can be briefly summarized here.

For most of the first half of 1968 the Bank gave top priority to the defence of the exchange value of the Canadian dollar. Bank Rate reached a peak of 7½ per cent in mid-March and was maintained at that level to the beginning of July. Market interest rates rose to the highest levels that we had ever experienced in this country up to that time. Bank liquidity declined and the rate of expansion of the banking system slowed markedly. The defence of the Canadian dollar—which involved many important measures in addition to those related to monetary policy—turned out to be completely successful and by early summer Canada's external financial position was again strong.

Once the exchange crisis in Canada had been overcome, a move to lower interest rates was generally expected and considered to be appropriate. Moreover, the view was developing that inflationary pressures were on the wane. Unemployment in Canada ranged between 5 and 5½ per cent in the summer and a marked slowing of economic growth in the United States was widely regarded as imminent. As the Bank of Canada moved to make monetary policy less restrictive and reduced the Bank Rate in three steps from 7½ to 6 per cent, the banks bought Government of Canada securities in large amounts. Market rates of interest declined, though they did not fall back to the levels that had prevailed before the exchange problem developed. As a result of the large purchases of Government securities, there was a sharp increase in bank liquidity and in the total size of the banking system.

By the end of the summer it had become evident that the widely expected change in the economic climate in North America was not yet developing, and the Bank of Canada felt that there should be no further increase in the banks'

holdings of more liquid assets. Accordingly, we managed cash reserves in such a way that the chartered banks' holdings of such assets ceased to rise after mid-September, and the rate of expansion of the banking system was slowed. The changing expectations regarding the economic outlook were allowed to have their full impact on market interest rates, which rose gradually at first and more rapidly towards the end of the year. Long-term interest rates reached levels considerably higher even than those which had prevailed earlier in the year when the Canadian dollar was under pressure. Effective December 18 the Bank Rate was increased from 6 to 6½ per cent and the rise in market interest rates continued into 1969. A further increase in Bank Rate to 7 per cent was announced on February 28, 1969.

Over the year 1968, the average yield on long-term Government bonds rose from about 6½ per cent to about 7¼ per cent and other long-term yields also rose to record levels. At the end of 1968 the average yield on outstanding provincial issues was nearly 8 per cent, on municipal bonds about 8⅛ per cent, on corporate bonds more than 8¼ per cent, and the rate on first class conventional mortgages was 9 per cent or higher. It became much more difficult as well as more expensive to raise money in the bond market. The amount of new money raised in Canada by issuers other than the Government of Canada was much less in 1968 than in 1967, while the amount raised outside Canada increased considerably and included for the first time substantial issues in European markets. The Government of Canada, already a substantial borrower in 1967, increased the amount of new money it raised in Canada in 1968, and also borrowed abroad to add to exchange reserves.

The flow of credit through the banking system was large, though the cost of bank credit rose significantly. Total chartered bank assets grew by 14 per cent, the same percentage increase as in 1967. I am aware that the large increase in the size of the banking system has caused some concern, and I too regard it as high. However, in determining how far the central bank should allow the large demand for credit generated by the expansion of the economy and by Government requirements to be accommodated by an increase in the size of the banking system, we had to take into account not only the degree of tightness in the financial system as a whole but also the practical limitations on increases in interest rates that exist at any given time—for example, the additions to the already large cash requirements of the Government that would have resulted from the need to finance reserve accretions produced by any substantial increase in capital inflows. Moreover, the form that the increase in the liabilities of the banking system was taking was also relevant. The rise in currency and demand deposits (a definition of the "money supply" commonly used in the United States) was 6½ per cent in Canada in 1968. The considerably higher rate of increase in total bank deposits was accounted for by

large increases in the relatively high-yielding categories of non-chequable savings deposits and time deposit receipts. Deposits of this type are essentially similar to short-term liquid claims outside the banking system which are not included in any definition of the "money supply".

I have referred above to the fact that the Government's domestic borrowing requirements were very high last year. Despite strenuous efforts by the Government to sell a variety of issues carrying high interest rates to non-bank investors, at times with considerable success (particularly in the case of the two issues of Canada Savings Bonds which were sold during the year), there was only a very small net increase in the amount of Government of Canada securities held by domestic non-bank investors over the year. Virtually the whole of the net increase in Government securities outstanding was therefore reflected in an increase in the holdings of the banking system and of foreign investors. The chartered banks added $943 million to their holdings of Government securities, while the Bank of Canada, to provide for an increase in notes in circulation and an increase in chartered bank cash reserves, increased its holdings by $135 million. The increase in Government borrowing, while adding to the upward pressures on interest rates, therefore also had the effect of adding to bank liquidity and, of course, increasing the size of the banking system.

There has been no further net increase in the banks' holdings of Government of Canada securities since mid-September; and as bank loans have continued to rise, the ratio of more liquid assets to total assets in the banking system has been reduced. The reduction in the Government's borrowing needs which will result from the measures announced in October is important not only for its economic effect but also for its effect on financial markets. A reduction in the Government's cash requirements will tend to limit the growth of the banks' more liquid assets in the future. This underlines the importance of strict adherence to the programmes announced by the Government to control expenditures and limit borrowing in 1969.

INTERNATIONAL FINANCIAL DEVELOPMENTS. Further progress was made during 1968 towards arrangements to help provide for future world requirements of international liquidity. The outline of the plan for the creation of Special Drawing Rights which was approved at the Annual Meeting of the International Monetary Fund in September 1967 has since been developed by the Executive Directors of the Fund in the form of an amendment to the Articles of Agreement of the Fund. This amendment was approved by the Governors of the Fund in May 1968, and was then referred to all Fund members for acceptance. A bill providing for Canadian participation in the new arrangement is at present before the Parliament of Canada; in the course of committee hearings on the bill the Bank of Canada expressed strong support for the legislation. The machinery

proposed is workable and should be effective for its purpose, and I hope that the members of the Fund will proceed with despatch to complete the process of ratification so that the process of activation can be initiated.

During the course of 1968 the international monetary system was buffeted by a series of crises. These resulted from waves of speculation which followed the devaluation of sterling and were generated by doubts about the stability of the exchange rates of some countries. In addition to the continued lack of progress towards a better adjustment of the payments balances of the major countries, there were a number of special factors at work, such as those which contributed to the difficulties of the French franc. The threats to exchange stability called into play existing facilities for co-operative action among monetary authorities and led to several new initiatives in international finance in which Canada participated.

In the latter part of 1967 and the first quarter of 1968 the industrial countries co-operating in the Gold Pool gave up gold to the value of some $3,000 million in an effort to stabilize the price of gold in the free market. On March 17 the Governors of the central banks of the contributing members of the Gold Pool announced that they were stopping such sales and that they had agreed on new arrangements in respect of gold. These arrangements involve two separate markets, an official market among monetary authorities in which the price remains fixed at U.S. $35 an ounce, and a free market in which the price moves in response to the balance of supply and demand. Canada was not a member of the Gold Pool, but it responded affirmatively to an invitation to co-operate in the new arrangements. Canadian producers of gold who do not wish to qualify for assistance under the Emergency Gold Mining Assistance Act remain free to sell their output in the free market at prevailing prices, and those who wish to qualify are still required to sell their output to the Mint at the Canadian dollar equivalent of U.S. $35 an ounce. Instead of transferring gold it purchases to the Exchange Fund Account for inclusion in Canada's official reserves, however, the Mint now sells its gold in the free market, with the Bank of Canada acting as its agent. A request made in December 1967 by the Bank of Canada to banks and other financial intermediaries not to extend credit on gold nor to facilitate forward purchases of gold remains outstanding.

A fresh threat to the stability of the international monetary system arose in 1968 from the possibility that large conversions of sterling holdings by non-residents would cause intense pressure on the pound sterling. The facilities placed at the disposal of Britain to finance temporary reductions in sterling balances in 1966 had been fully drawn upon and repayment over a period of time was arranged in September 1968. At the same time a new initiative was taken to discourage the conversion into other currencies of sterling held by the countries of the sterling area. To assist Britain in working out suitable arrangements, a stand-by facility in her favour for U.S. $2,000 million was provided

by the Bank for International Settlements and twelve central banks. The Canadian share is U.S. $100 million, the Bank of Canada acting for Canada as agent of the Minister of Finance.

In November very large flows of funds from France to Germany developed as a consequence of a growing market view that the exchange rates of these countries might be changed. France had received a short-term facility from a group of central banks in the amount of U.S. $1,300 million in July, and following a meeting in Bonn of the Ministers and Governors of the Group of Ten countries in November a new central bank facility in favour of the Bank of France in the amount of U.S. $2,000 million was announced. The Bank of Canada participates in the latter facility to the extent of U.S. $100 million.

The Bank of Canada continues to participate in the network of central bank facilities in favour of the Bank of England that was set up at the time of the devaluation of sterling in November 1967. Our share remains at U.S. $100 million.

The network of reciprocal short-term facilities between the Federal Reserve System and a number of central banks was expanded during 1968, and at the end of the year it totalled $10,500 million. Canada's participation in this arrangement was increased from $750 million to $1,000 million in March.

The group initiatives referred to in the last few paragraphs illustrate at the same time the strains to which the international monetary system was subjected during 1968 and the closeness and effectiveness of international financial co-operation. Many of the initiatives taken in 1968 dealt with the symptoms of strain rather than the causes, and their contribution was therefore in the direction of providing time to find solutions to the underlying problems. Time is frequently essential if such solutions are to be found; it must, of course, be well used if anything of lasting value is to be accomplished.

The disturbances in foreign exchange markets in 1968 have led some people to urge again that we could best strengthen the international monetary system by providing for more flexibility of exchange rates. Without wishing to maintain that the present arrangements are necessarily the best that could be devised, it seems to me that there are three background considerations that it is important to keep in mind in considering the further evolution of the international monetary system.

The first is that the present Bretton Woods arrangements assign to exchange rate changes an important role in the correction of payments imbalances, but they limit their use to circumstances of "fundamental disequilibrium". Countries are expected to try to maintain external balance by appropriate adjustments in their domestic economic and financial policies, but they are not asked to sacrifice the economic goals of high levels of employment and real income on the one hand or of reasonable price stability on the other.

The second consideration is that by its nature an exchange rate involves more than one country, for it is the price of one currency in terms of other currencies. No country can therefore regard either its own exchange rate or those of others as matters of exclusively domestic concern. The determination of exchange rates is inevitably a proper subject for international consultation and agreement.

There is, finally, the basic question of what kind of an international environment countries want. The Bretton Woods approach attaches weight to the pursuit of stability in international economic relationships in order to encourage the growth of economic and financial transactions between countries. This reflects the view that a stable external environment helps countries to achieve their own economic goals, and that it is therefore in their own interests to try to manage their national affairs in ways that are consistent with that stability. It is a consequence of economic interdependence that each country must rely on its trading partners to manage their affairs in ways that are not disturbing to its economic life.

I therefore conclude that it is mainly to good national economic policies around the world that we have to look to make the international economic system work better. It is not easy to manage a modern economy in such a way that it moves towards its economic objectives without causing disturbance to other countries, but all of us must continue to try. There are hopeful indications that the efforts of recent years to encourage countries to examine their economic policies in a sufficiently wide framework are bearing fruit, and that governments and peoples are becoming increasingly prepared to take account of their international economic interdependence.

CANADA - U.S. FINANCIAL ARRANGEMENTS. The agreements between Canada and the United States in respect of their international financial relationships were dealt with twice in the course of 1968 by exchanges of letters between the Secretary of the Treasury of the United States and the Minister of Finance of Canada. The first of these occurred on March 7 and the second on December 17. The full texts of these letters appear in an Appendix to this Report.

The exchange of letters of March 7 exempted Canada from all the United States balance of payments measures affecting capital flows that are administered by the Federal Reserve System and the Department of Commerce. This action was of prime importance in enabling Canada to surmount its serious exchange crisis. It was matched by two steps on the Canadian side to ensure that the United States balance of payments position would not be impaired by the exemption. Canada declared its intention (1) to take any steps necessary to ensure

that its exemption from the United States programme did not result in Canada's being used as a "pass-through" by which the purpose of the United States balance of payments programme would be frustrated and (2) to invest its holdings of United States dollars in excess of working balances in United States Government securities which do not constitute a liquid claim on the United States, but with effective safeguards to Canada's position should its reserve levels require.

Steps were subsequently taken to implement the Canadian undertakings. On May 3 the Minister of Finance announced guidelines that had been accepted by the chartered banks following discussions with the Bank of Canada. On July 24 the Minister of Finance asked all other financial institutions operating in Canada to accept a similar guideline. On September 19, guidelines for Canadian incorporated companies other than financial institutions were announced by the Minister of Trade and Commerce. The texts of the statements made on these three dates and of a related statement made by the Minister of Finance on March 16, 1966 appear in an Appendix to this Report.

These various guidelines were designed within the framework of Canadian practices to provide the necessary protection to the United States payments position while at the same time causing a minimum interference with the normal activities of Canadian business. Our financial relations with the United States are so important that it is clearly in the national interest that Canadians should manage their affairs within these guidelines. The Bank of Canada is administering the guidelines which apply to the chartered banks, whose helpful co-operation it has received in this task.

In connection with the second understanding referred to above regarding the investment of Canada's holdings of United States dollars, Canada held at the end of 1968 U.S. $1,250 million of special United States Government securities, an increase of U.S. $1,050 million over the year.

The exchange of letters on December 17 dealt primarily with that part of the understandings between the United States and Canada which has to do with the level of Canada's official reserves. As reserves recovered during the summer and autumn from the low levels reached during the exchange crisis of the first quarter, increasing concern was expressed in Canada that the flexibility of Canadian monetary policy was in danger of being severely limited by the existence of a "target" level for Canadian exchange reserves under our agreements with the United States. In the December exchange of letters it was agreed that the understandings between the two countries do not require that Canada's reserve level be limited to any particular figure, and recognized Canada's need for flexibility with respect to reserve levels in order to accommodate the adaptation of monetary policy to the changing needs of the domestic economy, seasonal factors and other influences of a temporary nature. I welcome this clarification of our basic arrangements with the United States.

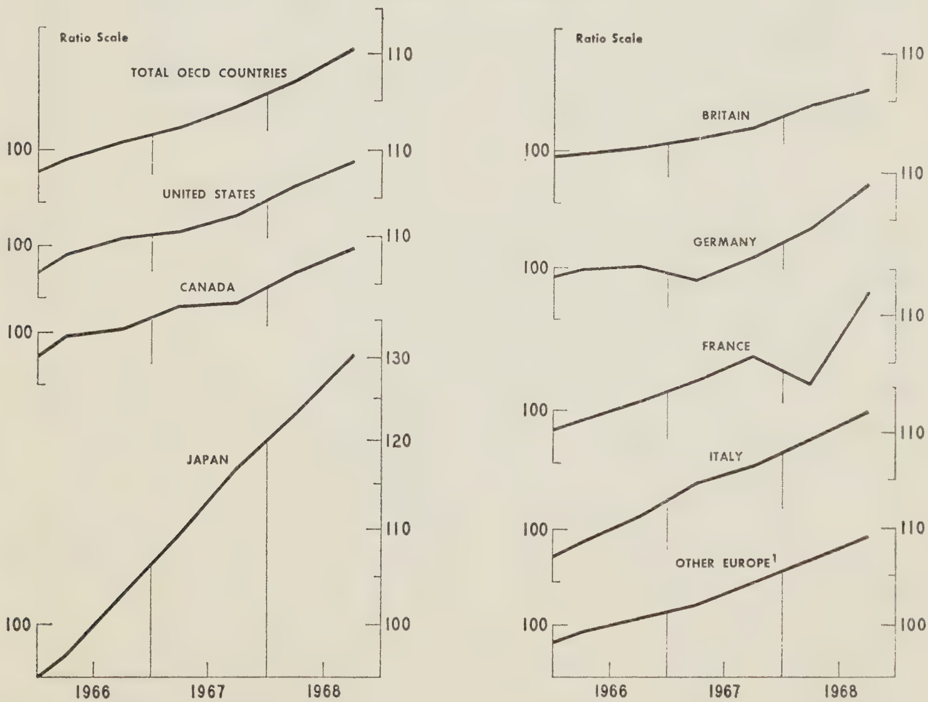
The External Environment

World output and employment expanded strongly in 1968. Total production in the OECD countries rose by more than 5½ per cent compared with 3½ per cent during 1967. In the second half of the year there was some slowing in the expansion in the United States and Britain, a recovery in France and an acceleration in Germany and in most other European countries.

GROSS NATIONAL PRODUCT

Constant Prices

Semi-Annual — Index 1966=100



Seasonally adjusted.

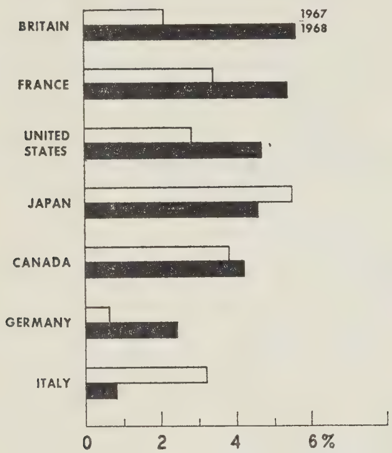
1968 preliminary estimates.

1. Austria, Belgium, Denmark, Greece, Iceland, Ireland, Luxembourg, Netherlands, Norway, Portugal, Spain, Sweden, Switzerland and Turkey.

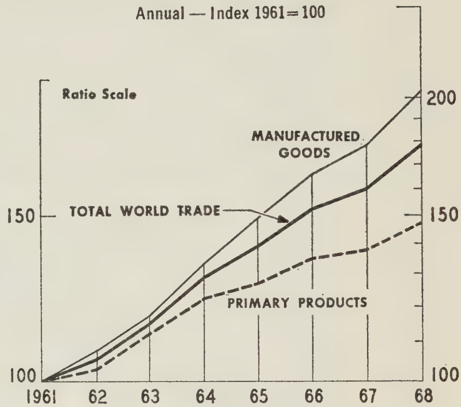
Cost and price pressures increased in most industrial countries. In Britain prices rose sharply, in part as a result of devaluation and higher indirect taxes. In France a large wage settlement in June was followed by a rapid rise in prices. Of most direct significance to Canada was the growth of inflationary pressures in the United States, where the rise in prices was greater than in any year since 1951.

CONSUMER PRICE INDICES

Percentage Increase : Year Ending Fourth Quarter



WORLD TRADE[1]



1968 preliminary.
1. Total exports f.o.b.

The rapid economic expansion in the industrial countries contributed to an increase of about 11 per cent in world trade. Trade in manufactured products continued to be the most dynamic sector, but the exports of many primary producing countries also rose strongly.

Unfortunately the growth in trade did not lead to a better balance in the current account positions of the major countries. In Britain a rising level of domestic demand led to higher imports, and the current account deficit increased from £400 million in 1967 to about £500 million in 1968. Although the current account position improved appreciably during the year it fell considerably short of the official target for the second half of the year. In the United States a rapid growth in imports led to the disappearance of the traditional current account surplus; it had been $1.7 billion in 1967 and the official objective for 1968 had been an improvement of about $1 billion. The high level of import demand in Britain and the United States contributed to a further increase in the already very large current surpluses of Germany and Italy, and to a strengthening of current account positions of many other countries, including Canada.

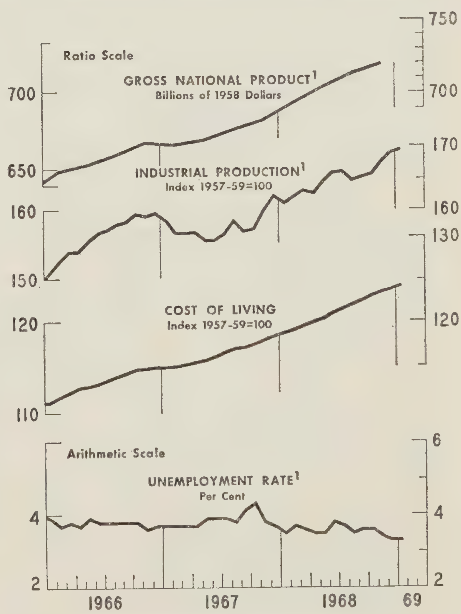
Restrictions on capital outflows by the reserve currency countries and the encouragement of capital outflows by the surplus countries contributed to a further increase in the activity of European capital markets in 1968. The Euro-bond market, an international market for new issues of long-term securities, handled issues totalling more than $3.5 billion in 1968, the major part being the obligations of overseas subsidiaries of United States corporations. In addition, a large volume of new security issues denominated in deutsche marks was sold in the German capital market during the year by foreigners, including the Government of Canada and a number of other Canadian borrowers.

The international flows of capital through these and other channels during 1968 were unusually large, and except for brief periods, they were helpful in moderating the impact on official reserves of movements in countries' current account positions. Nevertheless, doubts regarding the ability of some countries to cope with their payments imbalances without exchange rate changes contributed to large disequilibrating capital flows at certain times in the year, and these required substantial recourse to both existing and new international credit facilities.

Some of the highlights in economic developments during the year in the United States and, more briefly, in Britain, Germany, Italy, France and Japan are noted below.

In the *United States* the Gross National Product increased by 9½ per cent in value and 5½ per cent in volume during 1968, well above the increases of 5½ and 2¼ per cent respectively during 1967. The growth in real output of goods and services, which was at an annual rate of about 6 per cent in the first half of the year, moderated a little in the third and fourth quarters following enactment of the 10 per cent surcharge on personal and corporate income tax liabilities in June, but remained greater than had generally been expected. Consumer expenditures rose strongly in the third quarter, as the rate of personal saving declined simultaneously with the impact of the tax surcharge. In the fourth quarter consumer expenditures registered the smallest

UNITED STATES
SELECTED ECONOMIC INDICATORS

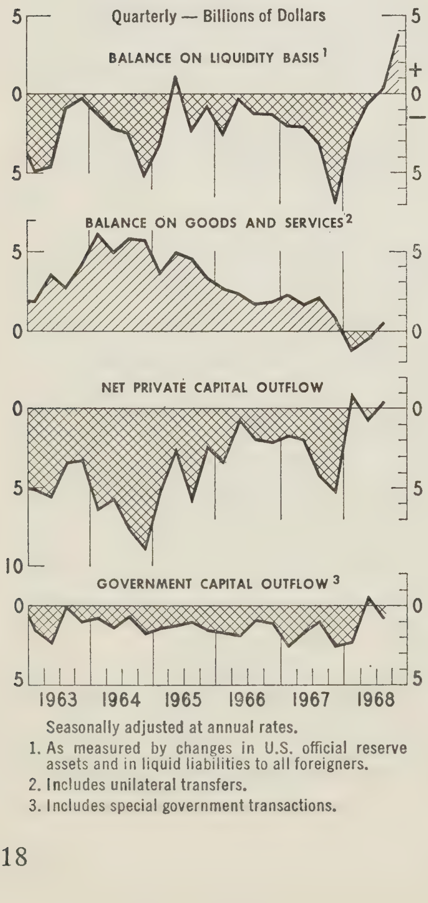


1. Seasonally adjusted (GNP at annual rates).

increase in more than a year, but private fixed investment showed unexpected strength and inventories were accumulated at a higher rate. The official United States forecast calls for an easing both in the rate of real growth and in the increase in prices in 1969.

The increase in employment fully absorbed the relatively small growth in the United States labour force in 1968. The seasonally adjusted unemployment rate averaged 3.6 per cent in each of the first three quarters, a little less than the 3.8 per cent average in 1967. Late in the year employment pressed even more strongly on the available labour supply and the unemployment rate dropped to 3.4 per cent in November and to a 15-year low of 3.3 per cent in December and January. The 5½ per cent increase in real output during 1968 was considerably larger than the 1¾ per cent rise in total employment, reflecting a significant improvement in output per worker. Increases in wages and fringe benefits resulting from labour contract negotiations in 1968 were larger than in the preceding year, and despite the improvement in productivity there was a further substantial rise in labour costs per unit of output. A 3.9 per cent increase in the GNP price deflator during the year compares with a 3.2 per cent increase during 1967; the Consumer Price Index rose by 4.7 per cent as against 3.1 per cent a year earlier.

UNITED STATES
BALANCE OF PAYMENTS



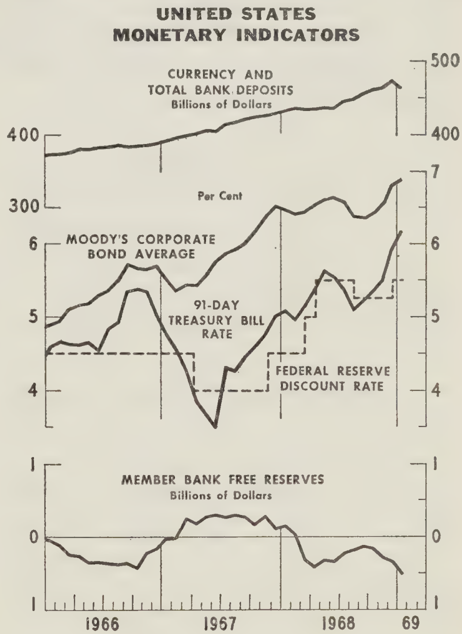
Seasonally adjusted at annual rates.
1. As measured by changes in U.S. official reserve assets and in liquid liabilities to all foreigners.
2. Includes unilateral transfers.
3. Includes special government transactions.

Strong economic growth in 1968 generated an exceptionally large increase in United States imports; they were also affected by actual or threatened strikes in the copper, aluminum and steel industries and by longshoremen. The growth in exports was not nearly so great and the United States trade surplus, which had amounted to $3.5 billion in 1967, virtually disappeared. This was offset in part by an improvement in the balance on service account, and the current account, including government grants and unilateral transfers, was apparently about in balance, compared with a $1.7 billion surplus in 1967.

As the result of a very large swing in the capital account the over-all international payments position of the

United States was roughly in balance on a liquidity basis in 1968, in contrast to a deficit of $3.6 billion in 1967. Mandatory controls on foreign direct investment announced at the beginning of 1968 greatly stimulated efforts of American firms to finance their foreign investment by borrowing abroad, particularly in the Euro-bond market. Foreign purchases of equities in the United States market also rose substantially, encouraged in part by political developments in France and Czechoslovakia, and there was a significantly larger inflow of funds from special financial transactions by United States and foreign official agencies.

During the first five months of 1968, in the absence of Congressional approval of the tax increase proposed by the Administration, monetary policy in the United States became progressively more restrictive in an effort to moderate inflationary pressures. Loans and investments of commercial banks increased at an annual rate of 7½ per cent after seasonal adjustment, compared with 12½ per cent during the second half of 1967 and there was a sharp swing from net free to net borrowed reserves at member banks. After a short period of easing at the beginning of the year, there was a renewed upward trend in interest rates. The Federal Reserve discount rate was raised to 5½ per cent in two half-point increases in March and April, and by mid-May most short-term rates had risen above the peak levels reached during the period of monetary restraint in 1966. Long-term rates also tended to move upward during this period and generally rose above the previous year's highs.



The legislation enacted in June providing for the 10 per cent surcharge on income taxes included a limitation on government expenditures. It is officially estimated that the budget will swing from the $25 billion deficit in the fiscal year ended June 30, 1968 to a surplus of $2.4 billion in fiscal 1969 and $3.4 billion in fiscal 1970. As prospects for fiscal restraint improved late in May interest rates began to move down again and by August they had returned to roughly the levels prevailing at the beginning of the year. Monetary policy became less restrictive during this period and the discount rate was reduced to 5¼ per cent in August. Beginning late in the summer, however, when the slowdown in business activity failed to develop to the extent anticipated, monetary policy

began to tighten again. Investor expectations changed and in the face of heavy credit demands the downward movement in interest rates was reversed. In December the discount rate was restored to 5½ per cent and by year-end most market rates exceeded their historical highs established earlier in the year.

In *Britain* domestic demand continued through 1968 at a higher level than was expected or desired. In the period between devaluation and the restrictive March budget, consumer expenditure rose sharply. The budget provided for both a substantial increase in revenues and a limited increase in government expenditures. The sharp rise in indirect taxes was designed to reduce personal consumption and provide scope for an expansion of exports and fixed investment within the context of a 3 per cent annual increase in total real output. Following the budget consumer expenditure fell but there was a substantial restocking of inventories. As the year progressed consumer demand reappeared as an expansionary element, stimulated by a larger increase in incomes than was envisaged in the budget. In November 1968, average weekly earnings in manufacturing were 7½ per cent higher than a year earlier. At the time of the budget the Bank Rate was lowered one-half point from the 8 per cent level fixed at the time of devaluation and it was reduced again by one-half point in September. On the other hand, credit to the private sector was curtailed throughout the period by ceilings imposed on bank lending. Short-term interest rates trended downward from the high levels reached in November 1967 while long-term rates were moving upward during the year.

The high level of domestic demand retarded the pace of external adjustment. In the favourable external environment, Britain's exports rose more than was expected but imports remained at the high level to which they had risen in the months following devaluation and the improvement in the trade balance was relatively small. The current account deficit totalled about £500 million in 1968 of which much the greater part was incurred in the first half of the year. Britain drew $1,400 million in June from the International Monetary Fund and had recourse to other credit facilities at various times during the year.

In November the authorities tightened hire-purchase terms, increased indirect taxes, imposed tighter credit restrictions, and introduced a system of prior deposits on imports. Bank Rate was raised by one point to 8 per cent on February 27, 1969.

The cyclical recovery of the *German* economy which had begun in 1967 picked up momentum during 1968. Total real output rose by about 7½ per cent with an even faster rate of growth in the second half of the year. The buoyant state of the economy was reflected in a firming of the labour market and income per employee, which had shown virtually no change during 1967, began to rise rapidly. However, productivity also rose strongly with the cyclical growth in output, and prices were relatively stable until late in the year.

Exports rose even more than imports and there was a substantial increase in the trade surplus. The current account surplus rose to $2.9 billion from $2.4 billion in 1967. Monetary policy continued to be relatively easy in 1968 and the prevailing credit conditions in Germany facilitated an export of private long-term capital of almost the same magnitude as the current account surplus. Although net new issues of fixed interest securities rose sharply during the course of the year, long-term interest rates continued to drift downward. The strong position of the deutsche mark and uncertainties regarding the French franc led to a short-term capital inflow of about $2.5 billion into Germany in the first three weeks of November. The Government announced a temporary subsidy on imports and tax on exports, in each case of 4 percentage points, and 100 per cent cash reserve requirements on any increase in credit institutions' liabilities to non-residents over the level of November 15, 1968. All of the November inflow of foreign exchange had been reversed by the first months of 1969.

In *Italy* there was a slight slowing in the pace of economic activity, and unemployment began to rise in 1968. Foreign demand was strong throughout the year but consumer demand eased markedly and inventories fell in the first half. Expansionary changes in fiscal policy introduced later in the year led to a more rapid growth in domestic demand and a strong recovery in imports. Despite some decline in the second half the current account surplus was about $2.5 billion for the year as a whole. However, capital outflows more than doubled in 1968 and official reserves fell slightly.

In *France* the course of economic activity was distorted by the May strikes. The pace of expansion accelerated rapidly after the settlement, stimulated by expansionary fiscal and monetary policies and higher incomes resulting from the large increase in wages. Imports increased and the balance of payments position deteriorated. A run on the French franc in November led to the imposition of tight exchange controls, the introduction of tax measures to stimulate exports and import substitution and a substantial cutback in the 1969 budget. Monetary policy was also tightened. For the year as a whole a substantial deficit in the balance of payments on current account and massive outflows of capital caused large losses of gold and foreign exchange; official reserves declined by $2.8 billion.

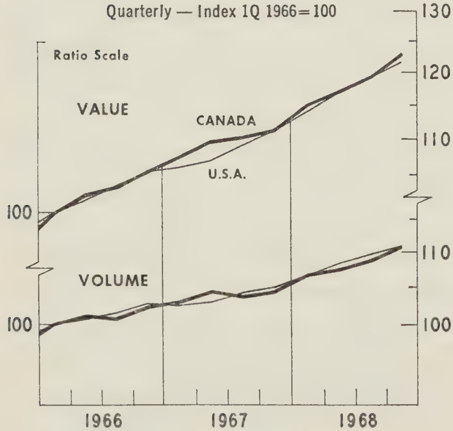
In *Japan* economic activity continued to grow rapidly and there were further substantial increases in costs and prices. Strong external demand resulted in a rapid acceleration in exports while the restrictive measures applied late in 1967 to correct a widening current account deficit resulted in a slowing down of imports and a decline in inventories. The current account position swung from a substantial deficit at the end of 1967 to a surplus which increased during the course of 1968. The outflow of long-term capital, which had been a feature of the Japanese economy in recent years, fell sharply in 1968 and official reserves rose by $860 million.

Economic Developments in Canada

Following a period of adjustment and slow growth which began in the spring of 1966 the Canadian economy resumed a strong rate of expansion towards the end of 1967. The recovery was spurred by a large increase in merchandise exports late in 1967 and early in 1968 which resulted from the strong resurgence of demand in the United States. In the course of 1968 additional momentum was provided by a record level of housing starts, by an acceleration in consumer spending on durable goods, by some recovery in business outlays on plant and equipment, and by the completion of the adjustment in business inventories. Employment responded to the revival in demand, but the labour force rose even more rapidly and productivity, which had failed to show any improvement over the period of slow growth in the economy, also picked up. As a result, the average level of unemployment was somewhat higher in 1968 than in 1967. At the same time increases in wages, salaries and profits outpaced even the faster growth in output in 1968 and prices continued to rise at about the same rate as in the two previous years.

GROSS NATIONAL PRODUCT
CANADA — U.S.A.

Quarterly — Index 1Q 1966=100



Seasonally adjusted.
Fourth quarter 1968 for Canada is estimated.

TOTAL OUTPUT. As the pace of economic expansion was moderating in the course of 1967 and accelerating in 1968, a conventional comparison of data for the two calendar years understates the extent of the growth during 1968. Between the fourth quarter of 1967 and the fourth quarter of 1968, seasonally adjusted GNP appears to have increased by about 10 per cent in money terms, of which about 6 per cent is accounted for by volume and some 4 per cent by price increase. The rate of real economic growth was thus almost as rapid as it was over the five-year period ending

in the second quarter of 1966 and three times as fast as it was during the adjustment period that followed. A comparison of the annual rates of increase in the major economic aggregates during these three periods is given in the following table.

ANNUAL PERCENTAGE RATES OF GROWTH
MAJOR ECONOMIC AGGREGATES
SELECTED PERIODS 1961-1968

	2Q 1961 to 2Q 1966	2Q 1966 to 4Q 1967	4Q 1967 to 4Q 1968
Gross National Product:			
Value	9.2	5.8	10e
Volume	6.5	2.1	6e
Price	2.5	3.7	4e
Real output per employee	3.1	−0.3	2½e
Employment(1)	3.3	2.4	3.3
Labour force(1)	2.4	3.2	3.7

e: Estimate.
(1) Includes Armed Forces.

Manufacturing output rose even more strikingly than total output. In the fourth quarter of 1968 it was 7 per cent higher than in the fourth quarter of 1967; this compares with an annual rate of increase of slightly more than one per cent over the previous year and a half. Particularly notable gains were recorded in steel, automobiles and lumber. Virtually all the evidence suggests that output was continuing to rise strongly as 1969 began.

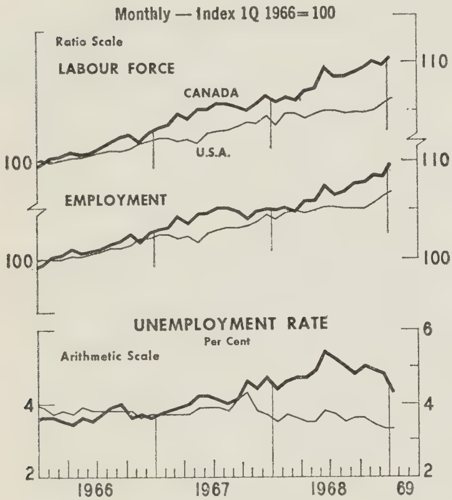
Agriculture also appears to have experienced a significant increase in the volume of output in 1968, but an unusually difficult situation has confronted western grain producers. While the crop harvested in 1968 was somewhat larger, adverse harvesting weather seriously lowered its quality. In addition, there have been marketing difficulties associated with the less ebullient demand for Canadian wheat in the past two years and aggravated by a variety of problems resulting from the damp condition of the 1968 crop, bottlenecks in transportation, and the congestion in storage facilities.

PRODUCTIVITY AND EMPLOYMENT. As shown in the above table the rapid expansion of the economy since the end of 1967 has been accompanied by renewed growth in productivity. In manufacturing, where productivity began to recover in the course of 1967, output per man-hour appears to have been at least 4 per cent higher in the fourth quarter of 1968 than a year earlier. These encouraging developments in productivity are, however, subject to an important qualification. They undoubtedly contain elements of a short-run nature

associated with the normal cyclical factors which affect productivity measures during a period of slowdown and subsequent re-acceleration in output. Over the whole period from the second quarter of 1966 to the fourth quarter of 1968 the productivity performance of the economy remains disappointing, as productivity appears to have risen by less than one per cent per annum.

Because of the improvement in average productivity in 1968, the recovery in employment was less pronounced than in output. At the same time the labour force was increasing more rapidly. As a result of these developments, the gradual rise in unemployment persisted until the middle of 1968 with the unemployment rate reaching a seasonally adjusted peak of 5.4 per cent in June when an unusually large number of students were seeking summer jobs. However, the unemployment rate fell somewhat in the second half of the year; in the fourth quarter it averaged just under 5 per cent, only slightly higher than in the same period a year earlier, and declined further in January 1969. For 1968 as a whole the unemployment rate averaged 4.8 per cent compared with 4.1 per cent in 1967. The civilian labour force was 3¾ per cent higher in the last quarter of 1968 than a year before, compared with an annual rate of increase of 3 per cent during the period of slower growth in output and employment. Net immigration was less in 1968 than in 1967 and there was little change in the rate of growth of the labour force attributable to demographic factors; the principal explanation for the faster rise in labour force was a higher rate of participation, especially by married women.

LABOUR FORCE AND EMPLOYMENT
CANADA — U.S.A.



Seasonally adjusted.

COSTS AND PRICES. The size of wage and salary increases in the collective bargaining sector showed some signs of moderating in 1968. There were again numerous instances of very large increases, but the weighted average of annual increases in base-rates in contracts negotiated during the year fell to 8.1 per cent compared to 8.7 per cent in 1967 contracts and 8.3 per cent in 1966 contracts; the average increase in the fourth quarter of 1968 was 7.5 per cent. The 1968 average remained somewhat higher in Canada than in the United States, though

the increases negotiated under collective bargaining in the United States were slightly larger than in 1967.

The most comprehensive figures available on average wage and salary earnings relate to employees in larger industrial establishments; they exclude government employees and cover only slightly more than half the number of paid workers indicated by the labour force survey. They cover a considerably larger proportion of the work force than that covered by collective bargaining arrangements and, because they include salaried workers, are more representative than figures pertaining to hourly-rated employees only.

AVERAGE WEEKLY WAGES AND SALARIES YEAR-OVER-YEAR PERCENTAGE INCREASE

(three months ending November)

	1966	1967	1968
Manufacturing	6.1	6.4	8.1
Mining	7.1	8.0	8.3
Forestry	8.2	10.5	4.6
Construction	12.0	6.5	6.3
Transportation and utilities	6.0	7.9	8.3
Trade	4.8	5.8	8.0[e]
Finance, insurance and real estate	5.1	5.8	9.1
Other commercial services	6.3	7.1	5.1
Total of above	6.3	6.2	7.4

e: Estimate.

On the basis of these figures, it would appear that in the business sector of the economy, at least, average earnings rose significantly more in 1968 than in the two previous years.

The total of wages, salaries and supplementary labour income (including military pay) in the non-farm economy is estimated to have increased by more than 9½ per cent between the fourth quarter of 1967 and the fourth quarter of 1968, compared to an increase of 7½ per cent in the previous year. Real GNP excluding agriculture is estimated to have increased by almost 6 per cent during 1968 compared to less than 3 per cent during 1967. Thus, labour costs per unit of output in the non-farm economy are estimated to have risen by about 3½ per cent in 1968, compared with about 4½ per cent in 1967 and more than 7 per cent in 1966. While the increase in 1968 was still appreciably greater than the 2 per cent average increase over the period from 1952 to 1965, it appears to have been slightly less than that which occurred in the United States where unit labour costs in the non-farm economy rose by an estimated 4 per cent in 1968.

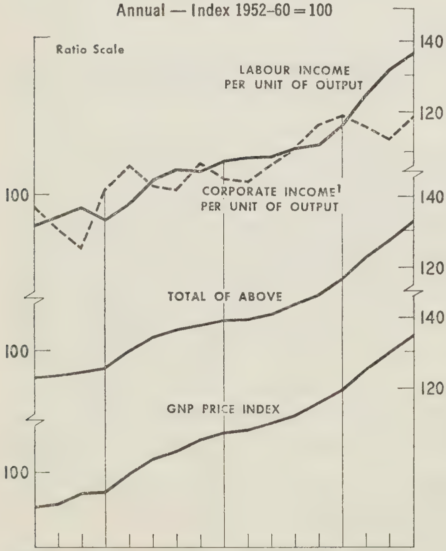
It is particularly useful to compare output, costs and productivity in the manufacturing sector of the Canadian and United States economies, because it is

the sector of most direct relevance to the relative competitive position of the two countries. The results are summarized in a series of charts on page 27. These comparisons suggest that, in manufacturing, output per employee increased more in Canada than in the United States in 1968 while income per employee rose less rapidly. As a result, unit labour costs in Canadian manufacturing increased by some 2 per cent between the fourth quarter of 1967 and the fourth quarter of 1968 while they rose by about 4 per cent in the United States. The increase in Canada was less than half the high rate of increase over the previous two years whereas unit labour costs in United States manufacturing rose somewhat more rapidly than in the earlier period. Consequently, the deterioration in the competitive position of Canadian manufacturing which occurred in 1966 and 1967 appears to have been recouped over the course of 1968.

While non-farm unit labour costs increased more slowly in 1968 than in the two previous years, profits per unit of non-farm output, which had declined in 1966 and 1967, reversed this decline in 1968. In the non-farm economy, as may be seen in the accompanying chart, corporate income (before taxes and depreciation) per unit of output in 1968 just about returned to its 1965 level. As a result, the combined total of corporate and labour income per unit of output rose by about the same percentage in 1968 as in 1967, and by about the same percentage as the GNP price index.

LABOUR COST AND PROFITS IN THE NON-FARM ECONOMY AND PRICES

Annual — Index 1952-60 = 100



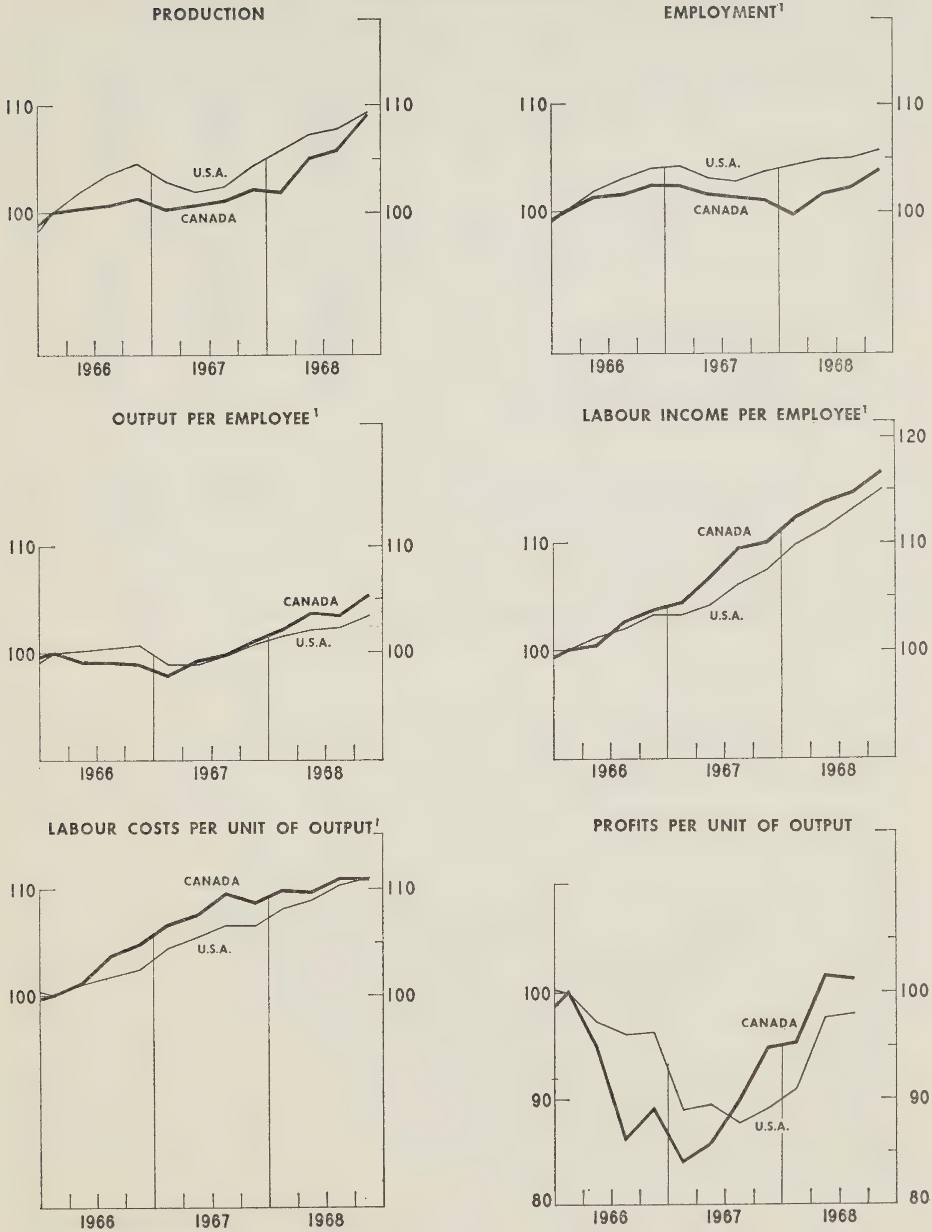
1968 estimated on basis of first 9 months.

1. Corporation profits before taxes and capital cost allowances.

Both the GNP price deflator and the Consumer Price Index rose by about 4 per cent between the fourth quarter of 1967 and the fourth quarter of 1968. In both cases this was a somewhat larger increase than occurred during the preceding twelve-month period. In fact, in the case of the Consumer Price Index the increase of 4.2 per cent over this period was the largest during any year since 1951. Food prices, which increased by 3½ per cent during 1968 compared to about 2 per cent during 1967, were a factor in the acceleration of the total index last year; but the index of all other items combined again registered a large increase of almost 4½ per cent as it had during 1967.

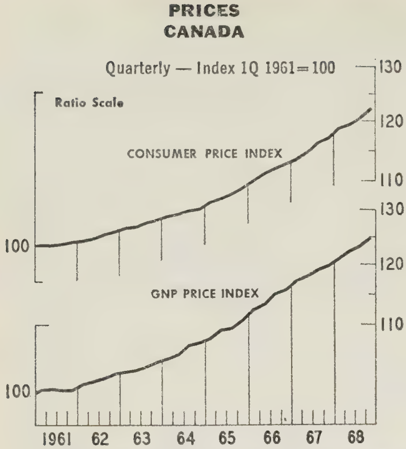
INCOME AND PRODUCTIVITY IN MANUFACTURING
CANADA - U.S.A.

Quarterly — Index 1Q 1966=100

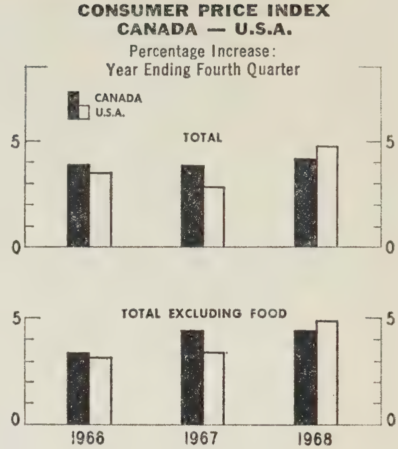


Seasonally adjusted.

1. Fourth quarter 1968 for Canada is estimated.



Seasonally adjusted: CPI adjusted by Bank of Canada.
Fourth quarter 1968 GNP Price Index is estimated.



In 1968 for the first time in several years price increases in Canada were no larger than in the United States. Indeed, the increase in consumer prices was greater in the United States—4.7 per cent between December 1967 and December 1968, as against 4.1 per cent in Canada. For both countries the GNP price deflator rose by about 4 per cent during the course of the year.

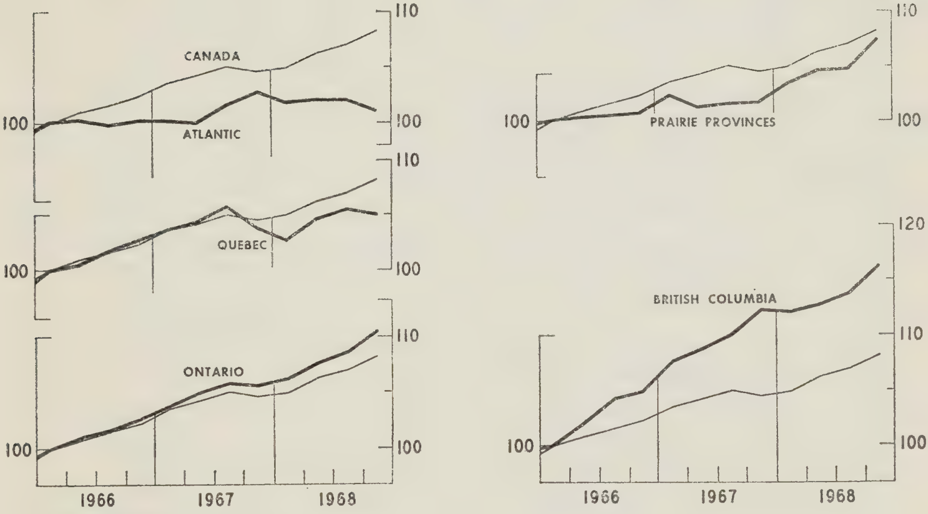
REGIONAL DEVELOPMENTS. Although regional comparisons differ considerably on the basis of the various statistical series available, the resumption of faster growth in the national economy in 1968 had, on the whole, less impact on Quebec and the Atlantic region than on the rest of the country. Ontario appears to have led the recovery, reflecting its predominant industrial position especially in such buoyant areas as steel and automobiles; British Columbia also benefitted markedly from the stronger demand for the products of forest-based industries, particularly lumber. Most indicators for Quebec suggest that expansion may have been less vigorous in 1968 than in the previous year when Quebec's performance significantly exceeded the national average as a result in part of activity in the Montreal region related to Expo '67. In the Atlantic Provinces, tourist expenditures recovered strongly following some loss of business to Expo in 1967, and the major goods-producing industries in this region also appear to have grown somewhat more rapidly than in the previous year though perhaps less than the national average.

All regions shared in the substantial increase in residential construction last year. Business investment which, on the basis of a calendar year comparison,

was little changed in most parts of the country continued to rise strongly in Newfoundland and appears to have been significantly higher in the Prairie Provinces in 1968 than in 1967. On the other hand, farm cash income, which increased slightly elsewhere, declined fairly sharply in the Prairies as a result of the difficulties already mentioned relating to the 1968 grain crop; despite the strength in many non-farm sectors of the Prairie economy, retail trade in that region showed the smallest gain of any except Quebec.

REGIONAL EMPLOYMENT

Quarterly — Index 1Q 1966=100



Seasonally adjusted.

During the adjustment period of 1966-67, employment in most parts of the country grew more slowly than in the years of rapid expansion and unemployment rates increased in all regions. In Quebec the growth in employment remained strong through the summer of 1967 due to Expo-related activity in the Montreal region, then fell off towards the end of the year. Considerable differences among the major regions are evident in the period of rapid growth in the national totals of output and employment since the latter part of 1967. On the one hand, there has been a strong demand for labour in Ontario and the West and the rise in unemployment in those regions has been checked. In Quebec and the Atlantic region, on the other hand, the demand for labour has shown little change and unemployment continued to rise during 1968. These labour market developments are summarized in the table on page 30.

REGIONAL LABOUR MARKETS

	Labour force		Employment		Unemployment rate		
	Annual rates of change(1)				Seasonally adjusted		
	2Q 1966 to 4Q 1967	4Q 1967 to 4Q 1968	2Q 1966 to 4Q 1967	4Q 1967 to 4Q 1968	2Q 1966	4Q 1967	4Q 1968
Atlantic Provinces	2.5	−0.6	1.7	−1.7	5.8	6.8	7.8
Quebec..........	2.9	2.7	2.1	1.4	4.8	5.8	7.0
Ontario..........	3.7	4.8	2.9	4.9	2.3	3.5	3.4
Prairie Provinces.	1.3	5.9	0.8	5.7	1.9	2.7	2.8
British Columbia.	7.7	3.6	6.6	3.8	4.5	5.9	5.7
Canada..........	3.3	3.8	2.5	3.4	3.5	4.5	4.9

(1) Derived from seasonally adjusted data.

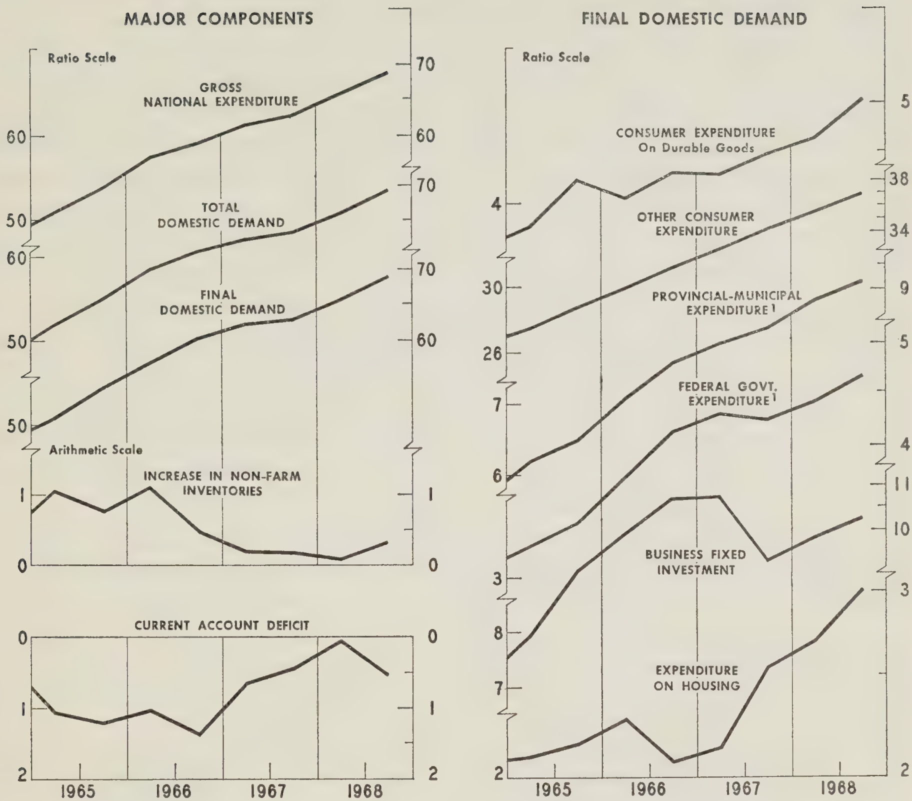
DOMESTIC DEMAND. Although the initial stimulus leading to the recovery of economic activity during 1968 appears to have been external demand, most components of domestic demand were advancing strongly by the end of the year. The rate of growth of GNP apparently moderated slightly in the second half of the year but domestic demand, which had increased at an annual rate of 8½ per cent between the second half of 1967 and the first half of 1968, rose at an estimated rate of about 10½ per cent from the first half to the second half.

Consumer expenditure, which had continued to increase quite strongly during the adjustment period, showed persistent strength in 1968 and in the second half of the year it was running some 8½ per cent above the corresponding period of 1967. In the aggregate, the increase in consumer spending was not much larger than in the preceding year, but there was a marked increase in the demand for durables (notably for new automobiles) which rose by 13 per cent between the second half of 1967 and the second half of 1968, compared to an increase of 4 per cent over the preceding year. The growth in total consumer outlays fell somewhat short of the estimated increase of about 10 per cent in total personal income. However, when allowance is made for an increase of some 20 per cent in personal direct tax payments, the rise in consumer expenditure during the past year has exceeded the rise in personal disposable income, and the rate of personal saving has fallen slightly.

The recovery in residential construction had preceded the resumption of more rapid growth in the economy and various measures adopted to increase the supply of mortgage funds facilitated a sharp expansion in housing activity in 1968. Starts totalled almost 197,000 dwelling units, far exceeding the previous peak of 167,000 in 1965 and the 1967 total of 164,000. Of more immediate importance, in view of the relative scarcity of housing accommodation which had developed after the 1966 squeeze on mortgage markets, completions recovered

COMPONENTS OF DEMAND

Semi-Annual — Billions of Dollars



Seasonally adjusted at annual rates.
Last half 1968 includes an estimate for fourth quarter.

1. On goods and services only; does not include transfer payments.

sharply from their relatively low level of 150,000 units in 1967, to a new record of about 170,000 units. In the second half of 1968 total outlays on house building were running almost 20 per cent above the level a year before, although as much as a third of this increase reflected the continued sharp increase in costs. The high level of activity at year-end is illustrated by the fact that 127,000 units were under construction compared with 103,000 a year earlier.

Outlays for new plant and equipment, after declining through 1967, have been rising again since the beginning of 1968. While the available estimates in this area are still subject to sizeable revision, outlays are estimated to have been some 5 to 10 per cent higher in the second half of 1968 than in the corresponding period of 1967. The strength of export demand which developed towards the end of 1967 and the accompanying strong recovery of profits undoubtedly

provided incentive for, and facilitated the financing of, the revival in investment.

Investment in inventories did not increase significantly until the third quarter of 1968. This may reflect some difficulty encountered by producers in expanding output quickly enough to meet the sharp increase in final demand and to provide desired increases in stocks consistent with a higher level of activity. Following some reduction of non-farm business stocks in the fourth quarter of 1967, there was little net accumulation in the first half of 1968 and such rebuilding of stocks as may have occurred in the last half of the year seems to have been of modest proportions. While the book value of manufacturers' inventories increased more rapidly after mid-year, the strength of shipments in the second half of the year prevented any rise from occurring in stock-sales ratios.

After allowing for quarterly irregularities, expenditures on goods and services by all levels of government combined appear to have increased at a rate of about 10 per cent during 1968, somewhat more than during the preceding year but appreciably less than in 1966. Wages and salaries of government employees and capital outlays in such areas as education have been major elements in the continued increase. The stability in defence expenditure in 1968 was a moderating element at the federal level.

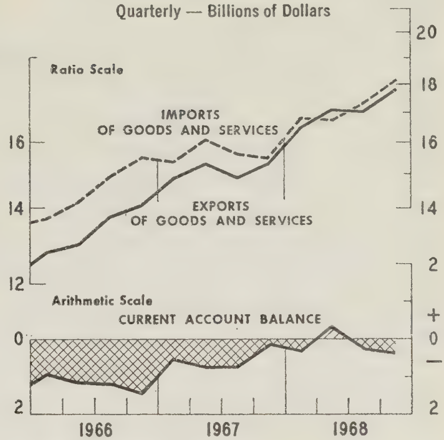
On a calendar year basis, the total of all governments' expenditure including all transfer payments but excluding loans and similar financial transactions increased by about 11 per cent in 1968 compared with 13 per cent in 1967 and 15 per cent in 1966. With increased rates of personal and corporation income tax and of indirect taxes, total government revenues rose by about 12 per cent, slightly more than in the previous two years. Additional increases in taxation introduced in the federal budget on October 22, 1968 take effect in 1969.

With government revenues rising more rapidly than expenditures, the net deficit of all governments combined was reduced by about $100 million in 1968. In addition, the total of net loans and advances by all governments to their own enterprises and to the private sector decreased moderately in 1968.

CURRENT ACCOUNT OF THE BALANCE OF PAYMENTS. The sharp acceleration in the demand for Canadian exports from late 1967 to mid-1968 emanated primarily from the United States where a strong general demand for imports was augmented by strikes or threatened strikes in the copper, aluminum and steel industries. It came at a time when imports into Canada were rising more moderately, as investment in machinery and equipment had eased and an adjustment was occurring in business inventories. The resulting sharp improvements in the current account balance on goods and services directly accounted for about one quarter of the total growth in Canadian production from the third quarter of 1967 to the second quarter of 1968. With the removal of strike-related import demand in the United States, our exports increased less rapidly

in the second half of the year, while imports rose more quickly as investment in machinery and inventories picked up. The consequent weakening of the current account balance moderated the impact on Canadian resources of the resurgence of domestic demand in the second half of the year.

CURRENT ACCOUNT OF THE BALANCE OF PAYMENTS

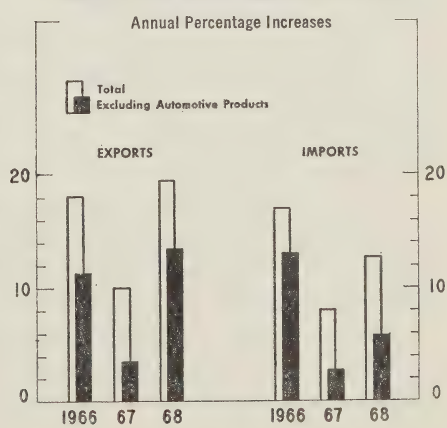


Balance of payments basis.

Analysis of Canada's balance of payments for 1967 and 1968 is rendered difficult by a large discrepancy in the official statistics between the direct estimates of the current and capital accounts, which leave a substantial residual of unidentified net payments to non-residents. In the statistics, the balancing item is attributed to the capital account but part of it may in fact reflect an underestimation of current payments or an overestimation of current receipts. The published estimates show the current account deficit declining from $1,162 million in 1966 to $543 million in 1967 and to $181 million in 1968, with all of the reduction in the two years being in transactions with the United States.

The merchandise trade surplus rose sharply in 1968; the recorded statistics show an increase from $481 million in 1967 to $1,295 million in 1968. Rapidly rising exports and imports of automotive products contributed substantially to the growth in merchandise trade last year, as they have each year since the signing of the Canada - United States automotive agreement in 1965. Our statistics show an increase in exports of automotive products to all countries of more than 50 per cent in 1968. The rise in our imports of these products was almost 40 per cent and the import balance, which had declined sharply in 1966 and 1967, fell only slightly in 1968.

GROWTH IN MERCHANDISE TRADE



Excluding automotive products, exports rose by 13½ per cent in 1968 following a 3½ per cent increase in 1967, while imports rose by nearly 6 per cent compared with a 2½ per cent increase in 1967. Both exports and imports were facilitated in 1968 by the

first stage of reductions in customs tariffs under the Kennedy Round. Higher prices contributed a little more to the increases in the value of exports and imports in 1968 than in 1967.

Exports to the United States of commodities other than automotive products showed an increase of 17½ per cent in 1968 compared with 6 per cent in 1967. This increase in Canadian shipments in 1968, though very large, fell short of the steep rise in the total of United States non-automotive imports from all countries. This may reflect the fact that Canada is not a major exporter of the many sophisticated manufactured goods which have been imported in increasing quantities into the United States in the past few years. While Canadian exports of copper, aluminum, iron and steel benefitted from special situations in United States markets late in 1967 and the first half of 1968, there does not appear to have been a major impact on our total exports for the calendar year. Excluding these categories as well as automotive products, the increase in our exports to the United States in 1968 was 15½ per cent.

Exports of wheat and flour, often a cause of major fluctuations in our exports to overseas countries, had declined sharply in the second half of 1967, largely as a result of reduced shipments to the Soviet Union and Mainland China. For the year 1968 they were slightly lower than in 1967; shipments to China rose sharply again but exports to most Western and Eastern European countries and to other Asian countries fell.

Canadian overseas exports of commodities other than wheat increased by nearly 12 per cent in 1968, about the same rate as in 1967. Shipments of automotive products rose sharply and exports of copper benefitted from the world shortage created by the strike in the United States. Shipments to Britain increased slightly less than in 1967, but sales to Germany, Belgium, Norway and South America rose more rapidly. Excluding wheat, exports of commodities to Japan, which had recorded an exceptional increase of 60 per cent in 1967, increased by 10 per cent in 1968.

Merchandise imports of commodities other than automotive products, as noted above, were only 6 per cent higher in the calendar year 1968 than in 1967. However, the value of such imports rose by nearly 11 per cent from the second half of 1967 to the second half of 1968, an increase more in line with the accelerating pace of domestic demand over the past year.

The statistics of Canada's international non-merchandise transactions show an increase in the deficit of about $450 million to $1,476 million in 1968. The larger deficit was due mainly to the loss on travel account of the benefits arising from Expo '67 and other Centennial attractions. Also, there was a further increase in net interest and dividend payments abroad which rose by $75 million to $971 million in 1968. On the other hand, larger transfers of funds to Canada by immigrants and smaller outright grants under official foreign aid programmes tended to limit the increase in the non-merchandise deficit.

Financial Developments in Canada

This section begins with a chronological account of the Bank of Canada's operations during the year, and goes on to describe financing activity and conditions in financial markets in Canada during 1968. The main forces shaping the course of financial events and central bank policy in Canada were the strong underlying demand for funds generated by public sector borrowing requirements and by vigorous economic expansion, the spread of inflationary expectations, and unsettled conditions in foreign exchange markets.

BANK OF CANADA OPERATIONS. During the early months of 1968 the dominant influence on monetary policy was the need to combat the sharp run on Canada's foreign exchange reserves. After the devaluation of sterling in November 1967, nervousness in exchange markets began to be reflected in speculative activity against several currencies, including the Canadian dollar; the value of the Canadian dollar declined from its upper limit to about its official par value during the latter part of the month. When central bank discount rates were raised in Britain and the United States in November 1967 the Bank of Canada raised Bank Rate from 5 per cent to 6 per cent, and through its cash reserve management in the latter part of 1967 it encouraged the rise in market rates of interest that was occurring. Overseas, there were heavy purchases of gold by speculators and in December, as a measure of international co-operation, the Bank of Canada requested Canadian banks and other financial intermediaries not to extend credit on gold nor to facilitate forward purchases of gold.

The announcement of the new United States balance of payments programme on January 1, 1968 brought greatly intensified pressure on the Canadian dollar. Although in designing the United States programme an effort had been made to minimize difficulties for Canada, doubts were raised about the basic viability of the Canadian balance of payments position in a situation where the country from which we drew the bulk of our external capital was restricting capital exports. The Canadian dollar weakened in both the spot and forward exchange markets as hedging of Canadian dollar positions by subsidiaries of

foreign companies and others developed on an unusual scale. Following discussions between Canadian and United States authorities the United States Treasury Department released a statement on January 21 making it clear that the new United States programme was not intended to produce abnormal transfers of funds from Canada to the United States by Canadian subsidiaries of American corporations and that it left room for large flows of capital to Canada. On the same date, the Bank of Canada announced that following discussions with the chartered banks it had been agreed that the banks would discourage the use of bank credit to facilitate abnormal transfers of funds abroad by Canadian subsidiaries of foreign companies and would also discourage the use of bank credit by such companies to meet financial requirements in Canada which had in the past normally been met by parent companies. It was announced that, effective January 22, Bank Rate was raised from 6 per cent to 7 per cent. At the end of January the Bank of Canada drew U.S. $250 million under its U.S. $750 million reciprocal currency facility with the Federal Reserve System.

Pressure on the Canadian dollar continued through February and into March as uncertainty arose concerning Canada's fiscal position and as concern about the international financial system again gave rise to extremely large purchases of gold in free markets around the world. At the end of February Canada drew U.S. $426 million from the International Monetary Fund. Of this amount U.S. $241 million represented Canada's creditor position with the Fund; the remaining U.S. $185 million, the equivalent of Canada's contribution of gold to the Fund, involved a repayment obligation. Early in March when Euro-dollar interest rates began to rise again the Bank asked the chartered banks and other financial intermediaries not to facilitate swapped* deposit transactions in foreign currencies, and the Minister of Finance asked Canadian investors not to enter into or renew swapped deposits through any intermediary, Canadian or non-Canadian. In the exchange market the forward discount on the Canadian dollar deepened further; this made speculative and hedging transactions more expensive.

It was clear, however, that the situation was unlikely to improve decisively unless a fundamental change could be secured in the conditions governing access by Canadians to foreign capital. On March 7, following discussions between Canadian and United States authorities, it was announced that the United States had undertaken to exempt Canada completely from all United States balance of payments measures affecting capital flows that were being administered by the Department of Commerce and the Federal Reserve System. On the same day, additional standby credits to supplement Canada's foreign exchange reserves

* Funds converted into a foreign currency, usually U.S. dollars, which have been placed on term deposit with a bank and which the bank has undertaken through a forward contract to convert back into Canadian dollars at maturity.

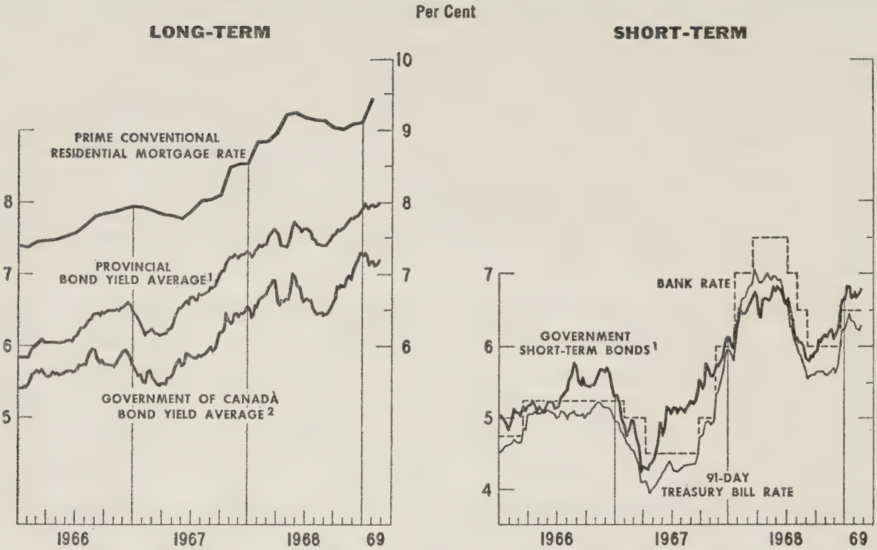
were arranged by the Bank of Canada for U.S. $100 million with the Bank for International Settlements, and for the equivalent of U.S. $150 million with the Deutsche Bundesbank and U.S. $150 million with the Banca d'Italia through the BIS. The Export-Import Bank of the United States opened a standby credit for the Government of Canada in the amount of U.S. $500 million. These standby credits represented an addition to the U.S. $500 million still available to the Bank of Canada under the reciprocal arrangement with the Federal Reserve System and the large credits totalling U.S. $740 million that would still be available to Canada by arranging further drawings from the International Monetary Fund.

Following the March 7 announcement the drain on Canada's foreign exchange reserves slowed down. It stopped completely after March 17, when confidence in the stability of the whole international monetary system was bolstered by the announcement that the participating Gold Pool countries had taken steps to halt the drain on their gold reserves caused by their sales in free markets. The Bank of Canada and the Department of Finance announced immediately their intention to co-operate in the new arrangements in respect of gold. On the same day the Bank's reciprocal credit facility with the Federal Reserve System was raised by U.S. $250 million to U.S. $1,000 million. Bank Rate had been raised by ½ per cent to 7½ per cent effective March 15, at the time of a similar increase in the rediscount rates of most of the Federal Reserve Banks.

The exchange losses suffered in the first eleven weeks of the year were very heavy. The official reserve figures (excluding the funds obtained through the drawings from the International Monetary Fund and the Federal Reserve System) show a decline of U.S. $707 million during the first quarter but the decline to the middle of March was greater: in the latter part of that month reserves began to increase and the rising trend continued strongly through the rest of the year.

Market rates of interest in Canada rose steadily in the first quarter of the year, with yields on treasury bills and Government of Canada bonds reaching the 7 per cent range and mortgage rates rising above 9 per cent. When the Federal Reserve Banks raised their rediscount rates in mid-April, however, the situation in Canada had improved to the point where it was not felt necessary to increase our own Bank Rate. To hasten the rebuilding of reserves the Government negotiated bond issues in Germany, Italy and the United States in May and June. The equivalent of U.S. $100 million in Government notes payable in lire was placed with the Italian Exchange Office, the equivalent of U.S. $62 million in Government notes payable in deutsche marks was offered through a German bank to European investors and U.S. $100 million in Government bonds was sold through a public offering to United States investors.

INTEREST RATES



Long-term:

1. Average weekly yield on the 10 provincial bonds included in the monthly series published by McLeod, Young, Weir and Co. Ltd.
2. Average weekly yield on Government of Canada bonds with a maturity of 10 years or over.

Short-term:

1. Average weekly yield on Government of Canada bonds with a maturity between 3 months and 3 years.

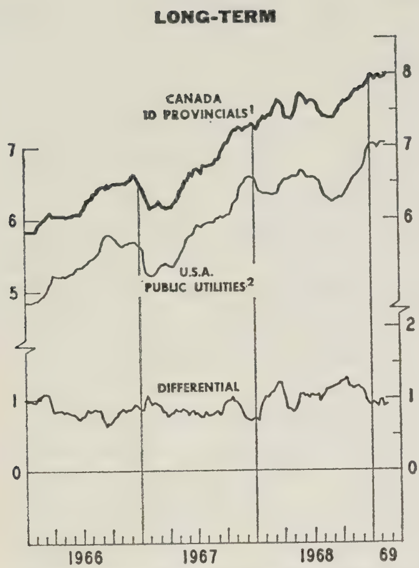
Of the last offering, U.S. $72 million was delivered in June, U.S. $13 million in October and U.S. $15 million in January 1969.

By mid-year the exchange crisis was clearly over and it was felt that the unusually tight credit conditions that had been necessary to help overcome it could be relaxed to some extent. Moreover, the long-discussed programme of fiscal restraint in the United States had finally been enacted and it appeared that the forces of economic expansion in North America would become less buoyant. The cash reserve position of the banking system was eased in June and with the market anticipating a sharp reduction in interest yields the banks became aggressive buyers of Government securities. The special guideline on foreign currency swapped deposits issued in March was withdrawn in mid-June. Also in June the Bank of Canada repaid U.S. $125 million of its drawing from the Federal Reserve System and reduced the standby credits with the Bank for International Settlements and the central banks of Germany and Italy from a total of U.S. $400 million to U.S. $250 million.

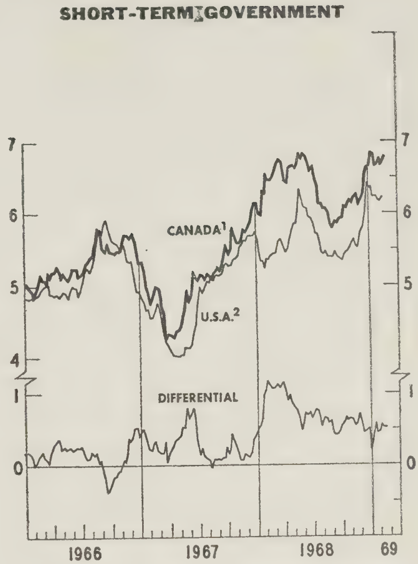
Bank Rate was reduced to 7 per cent on July 2, and to 6½ per cent on July 29. The Bank of Canada repaid the remaining U.S. $125 million of its drawing from the Federal Reserve System and terminated the standby credit

BOND YIELD COMPARISONS
CANADA - U.S.A.

Weekly — Per Cent



1. Average weekly yield on the 10 provincials included in the monthly series published by McLeod, Young, Weir and Co. Ltd.
2. Moody's Investors Service Inc. average yield on public utility bonds.



1. Average weekly yield on Government of Canada bonds with a maturity between 3 months and 3 years.
2. Average yield on United States Government bonds with a maturity between 9 months and 12 months.

facilities with the Bank for International Settlements and the central banks of Germany and Italy. By August the Bank of Canada's January request to the banks regarding loans to subsidiaries of foreign companies had become redundant because of the decline in demand for such loans in the preceding months and it was withdrawn.

Bank Rate was reduced to 6 per cent on September 3, following a reduction by the Federal Reserve Banks in the United States of their rediscount rates to 5¼ per cent in the latter part of August. By this time the Canadian treasury bill rate had declined by 1½ per cent from the peak level reached during the exchange crisis and long-term bond yields had fallen by ½ per cent. On September 13 the Government announced that it had discharged in full its repayment obligation to the International Monetary Fund and that the standby credit from the Export-Import Bank had been terminated. The Canadian dollar had been trading at or near its upper limit for about two months and the forward discount on the Canadian dollar had been substantially reduced. The combined total of official holdings of gold and U.S. dollars and Canada's net creditor position with the International Monetary Fund had been rebuilt to about the

level prevailing before the pressures on the Canadian dollar first appeared the previous November.

Towards the end of the summer a marked shift occurred in the immediate outlook for economic activity and credit conditions in North America. This shift was based on growing evidence that the United States economy was responding much more slowly than had been anticipated to the programme of fiscal restraint adopted in June. In Canada the gradual slowing of the rate of inflation which had seemed to be emerging around the end of 1967 and which had been expected to continue through 1968 appeared to have come to a halt. A high rate of monetary expansion had accompanied the decline in interest rates over the summer months and bank liquidity had been considerably increased through heavy bank buying of Government of Canada securities. A substantial upward revision of Government spending estimates was announced in September. In November renewed speculative activity in international currency markets provided an additional source of concern.

In these changing circumstances it seemed desirable to bring to an end the increase in chartered bank liquidity which had been occurring during the summer. The growth in the total assets of the banking system slowed during the remaining months of 1968 and January 1969, even though bank loans were rising at an accelerated pace. In late February 1969, the banking system's holdings of more liquid assets were about $150 million lower than they had been in mid-September 1968; as a proportion of total chartered bank assets they had declined from 32.6 per cent in September to 30.6 per cent in February.

Interest rates in Canada moved sharply upward again during this period, as they did in the United States. Effective December 18 the Bank Rate was raised by ½ per cent to 6½ per cent following an increase of ¼ per cent in the rediscount rate of the Federal Reserve Banks. By the end of the year long-term bond yields in Canada had risen appreciably above the previous peak levels reached during the exchange crisis.

As the cost of financing rose to new highs in 1968 some areas of the capital market experienced greater problems of availability of funds than others. The most difficult area in which to raise money was undoubtedly the domestic long-term bond market. The high interest costs and difficulty of floating new bond issues in the Canadian market induced borrowers to turn to the United States and then to European capital markets, to chartered bank credit, to the short-term money market and to the stock market. On the other hand, the supply of mortgage funds increased appreciably in 1968, and there was a sharp increase in consumer credit outstanding.

Operations by the Bank of Canada in Government of Canada securities during each month of 1968 are summarized in Appendix Table I. Market transactions resulted in a decline of $283 million in the Bank's portfolio over the year but other transactions resulted in an increase of $418 million so that

there was a net increase of $135 million. Market purchases or sales of Government of Canada securities were made by the Bank on about 90 business days in 1968; continuous contact was maintained with securities markets and the Bank participated, as usual, in the weekly treasury bill auctions. On occasion the Bank entered into temporary swaps of foreign currency assets with the Exchange Fund Account in order to adjust the level of Government cash balances at the chartered banks for cash reserve management purposes. Changes in the main balance sheet items of the Bank are shown in Appendix Table II.

Bank of Canada advances to banks were outstanding on 14 business days in 1968 compared with 24 days in 1967. The daily averages for 1968 and 1967 were $0.2 million and $1.1 million respectively. The Bank held securities under purchase and resale agreements with money market dealers on 35 business days during the year compared with 72 days in 1967 and the daily averages for these years were $4.3 million and $7.6 million respectively.

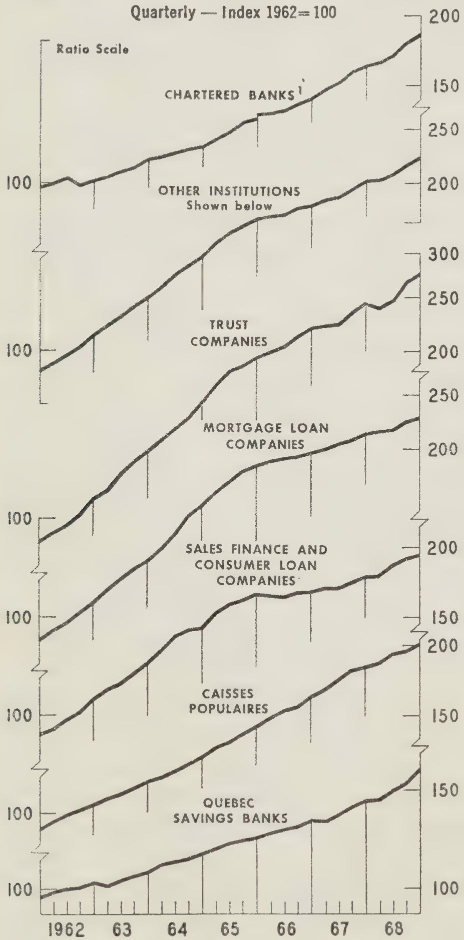
On October 25, 1968 the Bank gave formal notice that under Section 72(3) of the Bank Act the chartered banks would be required to maintain their statutory cash requirements on a half-monthly rather than a monthly basis beginning in January 1969. The object of this change is to increase the speed and predictability of response of the banking system to changes in the supply of cash reserves brought about by the central bank.

Coincident with the requirement that the chartered banks meet minimum requirements twice monthly for their average cash reserves, revised arrangements became effective governing their access to central bank credit. The changes took two forms. First, there was an increase in the normal line of credit for each of the chartered banks which reflected, in a general way, the growth in the banking system. Second, there was a reduction in the minimum period for which an advance could be taken. Formerly, advances were for a minimum of seven days and chartered banks were obliged to pay interest for the full period; under the revised arrangement, at the option of the chartered bank, an advance can be taken for a period of either 2 or 3 juridical days. As well, a bank may take an advance for one day on the last day of any averaging period, provided that on the preceding day its cumulative average cash reserve ratio was equal to or higher than its legal minimum ratio. While the central bank is conscious of its responsibility as a lender of last resort, it expects that each bank will be able in the ordinary course of events to adjust its cash position through the money market, that advances will be relatively infrequent, and that more than one advance to a bank in the same period will be rare. The first advance taken in an averaging period bears interest at Bank Rate; if a second or subsequent advance is required the rate in principle will be higher and will be negotiated.

To help money market dealers meet the increased demands which may be made on them as a result of twice-monthly cash reserve averaging, revisions were also made in the conditions of their access to purchase and resale facilities

at the central bank. The aggregate of their lines of credit was increased, and in order to modify the potentially destabilizing effect of access to a greater amount of central bank credit, the rate of interest applicable on usage beyond two thirds of a dealer's line was made subject to negotiation. In principle this rate will be higher than the Money Market Rate, which is applicable on the first two thirds of a dealer's line of credit. The Money Market Rate continues to be the lower of Bank Rate or of the latest average tender rate on three-month treasury bills plus one quarter of one per cent.

MAJOR CANADIAN ASSETS OF SELECTED FINANCIAL INSTITUTIONS



Seasonally adjusted.
1. Break in series reflects revised treatment of general reserves held against losses on loans and other assets.

CHARTERED BANKS AND OTHER FINANCIAL INSTITUTIONS. 1968 was the first full year in which the chartered banks operated under the terms of the revised Bank Act, the last remaining restrictions on bank lending rates having been removed at the end of 1967. The banks made vigorous use of their new freedom to compete on a price basis with other lenders and borrowers, seeking out profitable loan business and bidding strongly for savings and fixed-term deposit funds from the public which might otherwise have been invested in market securities or savings bonds. For the second year in a row the assets of the chartered banks grew at the unusually rapid rate of 14 per cent while those of competing institutions grew on average at an annual rate of close to 10 per cent; thus the size of the banking system in relation to other financial institutions, which had been declining for many years prior to the mid-sixties, continued to increase in 1968 as it had in 1967.

In the course of 1968 further changes occurred in the structure and operations of non-bank financial institutions directed towards improv-

MAJOR CANADIAN ASSETS OF SELECTED FINANCIAL INSTITUTIONS(1)

	Millions of dollars Dec. 1968	Percentage Increase			
		Average 1962-1965	1966	1967	1968
Chartered banks(2)	26,150	7.3	6.5	14.2	14.2
Other financial institutions					
Quebec savings banks	551	6.3	7.2	8.9	12.9
Trust companies	4,763e	21.3	13.4	10.9	13.2e
Mortgage loan companies	2,630e	19.7	5.5	8.0	6.9e
Sales finance and consumer loan companies	4,569e	15.8	1.0	6.6	9.6e
Caisses Populaires Desjardins de Québec	1,618	11.3	12.5	13.6	9.4
Sub-total	14,131e	17.1	7.1	9.1	10.4e
Life insurance companies (assets in Canada)	13,650e	7.4	6.2	6.5	5.7e
Trusteed pension funds	8,995e	12.6	10.8	11.3	11.5e
Mutual funds (assets valued at cost)	2,610e	24.7	21.6	14.5	19.1e
Sub-total	25,255e	10.1	9.0	8.8	9.0e
Total	65,536e	10.3	7.6	10.9	11.3e

e: Estimate.

(1) Excludes, insofar as available data make this feasible, fixed assets, foreign currency assets and investments in related companies.

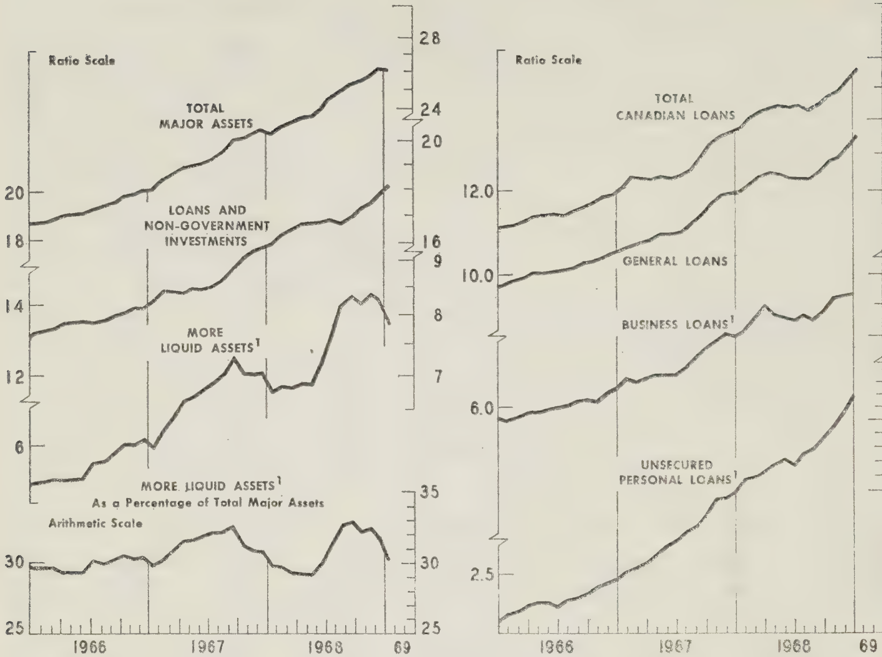
(2) Foreign currency assets of the banks are included net of their foreign currency liabilities.

ing their competitive position. In the trust and mortgage loan industry a number of mergers occurred. A bill is currently before Parliament to convert a savings bank in Quebec into a chartered bank. Sales finance companies, faced with increased competition in the financing of consumer durables, have directed more of their lending into areas such as residential and commercial mortgage lending and vehicle and equipment leasing. Some life insurance companies are now offering variable income annuities as well as equity funds in which dividends left on deposit can be invested.

While the cost of bank loans rose in 1968, they continued to be readily available to a wide range of borrowers. The banks' prime lending rates rose

CHARTERED BANK ASSETS

Average of Wednesdays — Billions of Dollars



Seasonally adjusted.
1. Includes net foreign assets.

Seasonally adjusted.
1. Month-end.

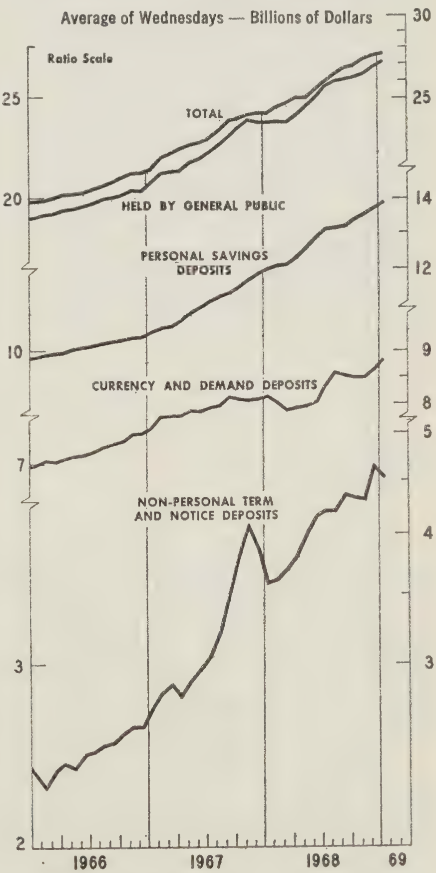
from around 6½ per cent at the beginning of the year to a peak of 7¼ per cent in the early spring, eased to 6¾ per cent over the summer months and then rose again to 7 per cent in January 1969. The Canadian dollar loans of the banks rose by more than 12 per cent during the year. The increase was particularly sharp for personal loans, loans to municipal governments and mortgage loans (about 20 per cent in each case) and in loans to grain dealers (about 50 per cent). Business loans at the chartered banks increased by 9 per cent in 1968, with a temporary bulge at the time of the exchange crisis and a temporary decline for a few months thereafter. As borrowing conditions in the bond market became more difficult again in the fall of 1968 and the early months of 1969, bank loans to business resumed their expansion.

The banks' holdings of Government of Canada treasury bills and bonds increased by $943 million, or 20 per cent, during 1968. The whole of this growth in the banks' holdings of these liquid assets occurred during the summer months: for an extended period prior to the summer bank liquidity had been declining, and since the end of the summer a downward trend has again been

in evidence. In late February 1969 the banks' ratio of more liquid assets* to total assets, at 30.6 per cent, was virtually the same as it had been at the beginning of 1968.

In the process of financing such a large increase in assets during 1968 the chartered banks bid very aggressively for savings and time deposits. Early in 1969 they were paying 6¾ per cent for large blocks of short-term funds and 5¼ per cent on non-chequable personal notice deposits, compared with 5¾ per cent and 5 per cent respectively at the beginning of 1968. The banks also competed strongly for the fixed-term deposits of persons: in late February 1969 they were typically offering yields of up to 7¼ per cent on large deposits for terms of over two years.

CURRENCY AND CHARTERED BANK CANADIAN DOLLAR DEPOSITS



Seasonally adjusted.

In total, the public's holdings of bank deposits and other liquid claims grew somewhat more slowly in 1968 than in 1967. Detailed figures are shown in the table on page 46. Currency and chartered bank demand deposits—the narrowest definition of private money holdings—increased by 6.6 per cent during 1968, compared with 8.1 per cent in 1967. Much the larger part of the increase in the public's holdings of currency and chartered bank deposits, which amounted to 13.3 per cent in 1968, consisted of high-yielding savings and fixed-term deposits; in 1967 the increase had been 16 per cent. There were also substantial increases in holdings of foreign currency deposits, short-term paper and trust company investment certificates. By contrast, resident non-bank holdings of Government of Canada market securities showed virtually no change during 1968, as will be seen from the table on page 47, and the increase in holdings of Canada Savings Bonds was quite small.

* Includes till money, deposits at the Bank of Canada, treasury bills, day-to-day loans, call loans, Government securities and net foreign assets.

GENERAL PUBLIC HOLDINGS OF CERTAIN FINANCIAL ASSETS

	Millions of dollars Dec. 1968	Percentage increase 1967	1968
Currency	2,991	9.8	9.3
Chartered bank demand deposits	5,869	7.2	5.3
Quebec savings banks' deposits	518	8.3	13.6
Caisses Populaires Desjardins de Québec deposits	1,399	12.7	8.2
Trust and mortgage loan company demand certificates and deposits	1,668e	5.2	7.1e
Sub-total	12,445e	8.2	7.1e
Chartered banks			
— personal savings deposits	13,461	14.7	15.8
— non-personal term and notice deposits	4,395	47.3	20.3
— foreign currency deposits of residents			
— swapped	845	12.2	−5.5
— other	1,193e	27.5	13.0e
Finance company short-term paper(1)	1,108	6.2	66.4
Other commercial paper(1)	317	34.4	28.9
Provincial and municipal short-term(1)	425e	16.0e	27.6e
Bankers' acceptances	116	−13.6	−20.5
Canada Savings Bonds	6,359	3.8	0.6
Trust company investment certificates	3,182e	12.9	16.2e
Mortgage loan company debentures	1,747e	11.2	5.7e
Sub-total	33,148e	15.0	13.0e
Total	45,593e	13.0	11.3e

e: Estimate.
(1) Resident holdings only.

SECURITIES MARKET FINANCING. Although the yield on bonds rose substantially in 1968—indeed to unprecedented levels—the flow of funds from non-bank sources to this area of the domestic capital market fell off sharply during the year. Funds available for investment from non-bank sources seem to have been directed in an increasing degree towards short-term instruments of fixed capital value, towards mortgages and towards equities and real estate.

Borrowers who in the past relied on long-term bond issues as their major source of financing have found themselves confronted with serious problems of availability and cost in raising new funds in the Canadian market. The problem has been most acute for governments and their agencies, which for many years have depended heavily on this type of financing in the Canadian market; they found themselves under growing pressure to cut back on the rising trend of their

NET NEW ISSUES OF SECURITIES

(millions of Canadian dollars)

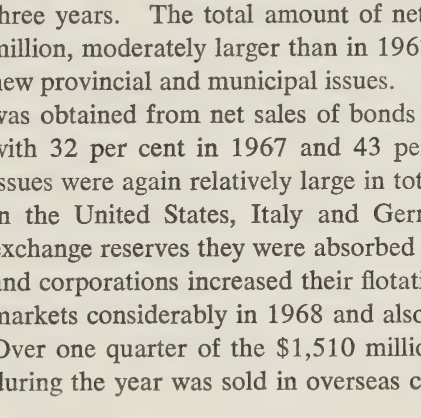
	1966	1967	1968
Funds raised through new issues of:			
Government of Canada bonds and treasury bills....	139	934	1,375
Provincial and municipal bonds and short-term paper........................	2,064	2,711	2,374
Corporate bonds and short-term paper...........	1,236	963	1,139
Sub-total.........................	3,439	4,608	4,888
Corporate stocks.............................	594	505	522
Total funds raised..................	4,033	5,113	5,410
Funds supplied by increase in holdings of:			
Resident non-bank investors			
— Canada Savings Bonds....................	223	229	40
— Government of Canada market issues.......	11	− 256	− 4
— Provincial and municipal bonds............	1,028	936	510
— Corporate bonds.......................	466	738	324
Sub-total.........................	1,728	1,646	870
— Corporate stocks.......................	677	448	339
— Short-term paper......................	190	124	576
Total non-bank residents...........	2,595	2,218	1,785
Canada and Quebec Pension Plans...............	601	814	880[e]
Bank of Canada			
— Government of Canada market issues.......	1	334	135
Chartered banks			
— Government of Canada market issues.......	167	740	943
— Provincial and municipal bonds............	− 69	83	50
— Corporate securities.....................	31	45	107
Total chartered banks..............	129	868	1,100
Non-resident investors			
— Government of Canada issues.............	− 263	− 112	261
— Provincial and municipal bonds............	454	808	854
— Corporate bonds.......................	603	169	358
Sub-total.........................	794	865	1,473
— Corporate stocks.......................	− 83	57	183
— Short-term paper......................	− 4	− 43	− 146
Total purchases of Canadian securities by non-residents........	707	879	1,510
Total funds supplied...............	4,033	5,113	5,410

e: Estimate

expenditures or to raise more revenue. In part their response was to borrow more where they could, by selling foreign currency issues in the United States and in European capital markets where funds were somewhat more readily available and interest costs somewhat lower than in Canada, although in some cases they accepted a relatively short term to maturity. Borrowers also had increased recourse to the chartered banks. Some corporate borrowers shortened the term of their obligations or attached conversion options or stock warrants to bond issues to improve their access to funds and lower their cost.

The table on page 47 summarizes the main trends in the supply and in the holdings of Canadian-debtor bonds, stocks and short-term paper during the past three years. The total amount of net new issue financing in 1968 was $5,410 million, moderately larger than in 1967 despite some reduction in the amount of new provincial and municipal issues. Of this amount, however, only 16 per cent was obtained from net sales of bonds to resident non-bank investors, compared with 32 per cent in 1967 and 43 per cent in 1966. Government of Canada issues were again relatively large in total; apart from foreign currency issues sold in the United States, Italy and Germany in order to bolster official foreign exchange reserves they were absorbed mainly by the banking system. Provinces and corporations increased their flotations of new bond issues in external capital markets considerably in 1968 and also their use of the short-term paper market. Over one quarter of the $1,510 million of net new issues sold to non-residents during the year was sold in overseas capital markets.

MORTGAGE MARKET INTEREST RATES



1. Previous to October 1967 N.H.A. loans were made at the maximum rates set by orders in council but since then actual rates have been below the maximum. From October 1967 the series is a monthly weighted average of the rates charged by approved lenders on home ownership loans.

MORTGAGE MARKET FINANCING. The cost of mortgage borrowing rose to record levels in 1968, with typical interest rates on new mortgages in the vicinity of 9 per cent. Demand for mortgage credit remained strong and the supply of mortgage funds from private institutional lenders continued to expand vigorously. As may be seen from the table on the facing page, all of the increase in mortgage lending appears to have been in the form of residential loans; non-residential mortgage lending is estimated to have declined slightly.

The volume of residential mortgage loans approved by private financial

institutions increased by about $600 million in 1968. As in 1967, the chartered banks (including mortgage lending subsidiaries) played an important part in this growth of mortgage lending; their approvals amounted to about $430 million in 1968, approximately double the 1967 figure. The relatively large increase in National Housing Act loans was associated with a narrowing in the interest rate differential between conventional and NHA mortgages which followed the change in the method of determining the NHA maximum rate in October of 1967. A change in NHA regulations in February 1968 made it permissible for approved lenders to earn current mortgage yields for a term of up to 25 years on NHA loans to corporate builders of multiple-dwelling projects. The decline of $220 million in direct lending by the Central Mortgage and Housing Corporation mainly affected the volume of lending to builders and individuals for the construction of single-family dwellings. Loans by CMHC for low-income housing remained close to their high 1967 level.

GROSS MORTGAGE LOAN APPROVALS

(millions of dollars)

	Residential mortgage loans approved							
	Private financial institutions[1]							
	Conventional							
	New	Existing	NHA	Total	CMHC	Total	Non-residential	Total
1966.........	574	471	191	1,236	593	1,829	382	2,211
1967.........	745	655	356	1,756	727	2,483	369	2,852
1968e........	962	572	831	2,365	503	2,868	335	3,203

e: Estimate.
(1) Includes: life insurance companies, chartered banks, trust and mortgage loan companies, Quebec savings banks, fraternal and mutual benefit societies.

BUSINESS FINANCE. On the basis of such information as is currently available it seems unlikely that business capital expenditures and business inventory accumulation increased substantially in 1968, but there does appear to have been a substantial increase in the cash flow generated internally by business enterprises in the form of profits and depreciation allowances. Consequently, the amount of external funds required by business to finance capital spending in 1968 would appear to have been considerably smaller than in 1967. However, the total amount of the main types of external borrowing by private business enterprises in 1968, insofar as such borrowing can be identified, seems to have been only slightly smaller than in 1967, as shown in the table on page 50. The explanation may be that businesses continued to rebuild holdings of liquid assets which they had depleted during the investment boom of 1966; it is also possible that they were borrowing in anticipation of higher investment spending in 1969.

MAJOR SOURCES OF BORROWING BY NON-FINANCIAL BUSINESS

(millions of dollars)

	1966	1967	1968
Net new issues of:			
Commercial paper and bankers' acceptances	60	29	29e
Bonds	913	762	655
Stocks	538	376	458
Sub-total	1,511	1,167	1,142e
Increases in:			
Chartered bank loans(1)	582	719	643
Sales finance company loans	— 213	64	187e
Industrial Development Bank loans	44	34	42
Sub-total	413	817	872e
Net direct investment from abroad	705	530	415
Total	2,629	2,514	2,429e

e: Estimate.

(1) Total business loans excluding provincially-guaranteed loans to utilities, plus loans to farmers and all foreign currency loans to residents.

CONSUMER CREDIT. The net amount of consumer credit extended in 1968 was $1,176 million; this represented an increase of 14 per cent in total consumer credit outstanding. There was again a substantial increase in unsecured personal lending by the chartered banks, who were also active in introducing new cheque guarantee and credit card plans. Consumer credit extended by sales finance companies, which had declined in 1967, increased again in 1968.

MAJOR SOURCES OF CREDIT EXTENDED TO CONSUMERS

(millions of dollars)

	1966	1967	1968
Net increase in consumer credit(1) extended by:			
Chartered banks (unsecured personal loans)	217	519	688
Consumer loan companies	120	140	161
Credit unions and Caisses Populaires	124	109	134e
Sales finance companies	53	— 79	68
Retail dealers(2)	60	43	65
Life insurance companies (policy loans)	39	36	56e
Quebec savings banks	–	1	4
Total	613	769	1,176e

e: Estimate.

(1) New extensions of credit less repayments.

(2) Includes credit extended by department stores, furniture and appliance dealers, motor vehicle dealers, other retail dealers and oil company credit cards.

GOVERNMENT FINANCING. As in the previous year, the government sector had recourse to financial markets for large amounts of borrowed funds in 1968. The major sources of government borrowing are summarized in the table below.

The outstanding amount of Canadian dollar securities of the Government of Canada (excluding securities held by Government accounts) rose by $1,109 million in 1968. Virtually the whole of this increase was in market issues of bonds and treasury bills, and was taken up by the chartered banks and the Bank of Canada. As shown earlier in the table on page 47 public holdings of Canada Savings Bonds increased by $40 million; holdings of market issues by resident investors other than banks were virtually unchanged over the year as a whole.

SELECTED SOURCES OF BORROWING: FEDERAL, PROVINCIAL AND MUNICIPAL GOVERNMENTS AND THEIR ENTERPRISES[1]

(millions of dollars)

	1966	1967	1968
Government of Canada			
Increase in securities outside Gov't accounts:			
— treasury bills	10	295	360
— Canadian-pay market bonds	70	454	709
— Canada Savings Bonds	223	229	40
Total Gov't of Can. domestic issues[2]	303	978	1,109
Provincial and Municipal Governments			
Increase in outstanding Canadian-pay bonds:			
— purchased by Canada and Quebec Pension Plan funds	601	814	880[e]
— other Canadian dollar issues	989	1,027	495
Increase in loans from:			
— chartered banks	139	124	− 4
— Government of Canada (including CMHC and MDLF)	205	175	276
Increase in short-term paper outstanding	50[e]	70[e]	80[e]
Increase in outstanding foreign currency issues	424	800	919
Total provincial-municipal borrowing[3]	2,408	3,010	2,646

e: Estimate.

(1) To obtain a total of combined federal, provincial and municipal financing without double counting, loans from the Federal Government to the provinces and municipalities would have to be eliminated, as well as changes in provincial-municipal holdings of Government of Canada securities.

(2) Changes in outstanding foreign currency issues of the Government of Canada during 1966, 1967 and 1968 respectively, in millions of dollars, were −164, −45, and +266. The increase in 1968 reflected new issues sold in the United States, Italy and Germany, the proceeds of which were used to bolster official foreign exchange reserves.

(3) To the extent that provincial government accounts purchase provincial or municipal securities the total of provincial-municipal financing is overstated.

In 1967, in order to finance total net cash requirements of $1,276 million, the Government had supplemented its net new issues of securities in the Canadian market by drawing heavily on its cash balances. In 1968, although the Government's net new Canadian issues were somewhat higher than in 1967, part of the proceeds were used to rebuild cash balances; total financing requirements for all other purposes amounted to $1,049 million. (See Appendix Table III) There was a substantial reduction in Government lending to the Central Mortgage and Housing Corporation and in the amount of Canadian funds required to finance the Government's net acquisition of foreign currency assets. On the other hand, the budgetary deficit was somewhat larger in 1968, and repayment began at mid-year of the refundable corporation tax, which had been a source of funds to the Government in 1967.

The combined borrowing requirements of provincial and municipal governments and their business enterprises in 1968 are estimated at $2,646 million, appreciably below the estimated figure of $3,010 million for 1967. The reduction in provincial-municipal borrowing was due in part to a further narrowing of the shortfall of their revenue below their expenditure and provincial lending to the private sector for industrial development, farm credit and residential construction slowed markedly during 1968. There appears to have been little change in the scale of capital outlays by provincial and municipal enterprises compared with the previous year.

Net new issues of provincial and municipal bonds sold in the domestic market in 1968 were approximately $530 million less than the amount sold in 1967. Net borrowing in the United States market was also down by about $170 million, but foreign currency borrowing in Europe, which had been negligible in past years, amounted in total to about $300 million in 1968.

PUBLIC DEBT MANAGEMENT OPERATIONS. The Government of Canada was again very active in the capital market in 1968. There were six offerings of marketable bonds in the domestic market; foreign currency issues were placed in Italy, Germany and the United States; there were two Canada Savings Bond issues; three offerings of special treasury bills were made, and the amount of the weekly bill offerings varied considerably during the year. The factors which gave rise to financing activity on this scale included the substantial domestic requirements of the Government arising out of its budgetary and non-budgetary transactions, and the abnormal extent of the decline in the amount of Canada Savings Bonds outstanding during much of the year when yields available on such bonds were exceeded by rates offered on competing deposit and investment instruments. The timing of new issues was affected by the unanticipated increase and subsequent decline in domestic cash balances as the Government first

SUMMARY OF DIRECT NEW ISSUES AND RETIREMENTS
GOVERNMENT OF CANADA MARKET BONDS

Date	Issues offered	Amount delivered (millions of dollars par value)	Years to maturity	Yield to maturity	Amount retired (millions of dollars par value)
		(Payable in Canadian dollars)			
1968					
Jan. 15	6% Feb. 15, '70	250	2 yrs. 1 mo.	6.20	
	6% Dec. 15, '71	200	3 yrs. 11 mos.	6.44	
		450			400
Apr. 1	5½% Apr. 1, '69	60	1 yr.	7.03	
	7% Apr. 1, '73	215	5 yrs.	7.30	
		275			275
Apr. 3					9(1)
June 15	6¾% July 1, '69	75	1 yr. ½ mo.	7.00	
	7% Oct. 1, '70	275	2 yrs. 3½ mos.	7.11	
	7% June 15, '74	250	6 yrs.	7.26	
		600			495
Aug. 1	6½% Dec. 15, '69	35	1 yr. 4½ mos.	6.65	
	6¾% Oct. 1, '70	105	2 yrs. 2 mos.	6.75	
	7% Apr. 1, '73	260	4 yrs. 8 mos.	7.00	
		400			
Sept. 13					100(2)
Oct. 1	6% Feb. 15, '70	35	1 yr. 4½ mos.	6.11	
	6¼% Oct. 1, '71	200	3 yrs.	6.25	
	6½% Apr. 1, '75	200	6 yrs. 6 mos.	6.60	
	6½% Oct. 1, '95	100	27 yrs.	6.60	
		535			260
Dec. 15	6¼% May 1, '70	50	1 yr. 4½ mos.	6.28	
	6¼% Apr. 1, '71	200	2 yrs. 3½ mos.	6.36	
		250			100
		(Payable in foreign currencies)			
Apr. 15					1(3)
May 15	5¾% May 15, '70 (lire)	35	2 yrs.	5.75	
	5⅞% May 15, '71 (lire)	36	3 yrs.	5.875	
	6% May 15, '72 (lire)	37	4 yrs.	6.00	
		108			
June 1	6¾% June 1, '73 (DM)(4)	68	5 yrs.	6.87	
	6⅞% June 1, '88 ($US)(5)	108	20 yrs.	6.90	
		176			
Oct. 15					1(3)

(1) Cancellation of 5½% Aug. 1, 1980 securities held by Government Securities Investment Account and/or Purchase Fund.
(2) Cancellation of Government Securities Investment Account holdings of 5% Oct. 1, 1968 securities.
(3) Partial redemption at par of $U.S. pay 5% Oct. 15, 1987 for the sinking fund.
(4) Net proceeds of deutsche mark issue credited to Government by underwriter on May 24, 1968.
(5) U.S. $100 million issue, of which U.S. $72 million delivered June 11, 1968; U.S. $13 million delivered Oct. 15, 1968, and U.S. $15 million delivered Jan. 15, 1969.

lost foreign exchange reserves when the Canadian dollar came under pressure and then recouped them later in the year.

The Government's borrowing was conducted in an environment of considerable uncertainty in the capital market and generally high and rising interest rates. For the most part, it continued to issue securities of relatively short term to maturity as is indicated in the table on page 53. An exception was the October 1 issue when $100 million of 27-year bonds were included in the offering.

As a means of offering investors a wider choice of maturities in connection with many of the 1968 debt operations, the Bank concurrently offered a variety of switch programmes. These programmes were of two types. One type represented an advance refunding operation, under which the Bank agreed to take a stated amount of a new issue from the Government in exchange for short-dated securities, and at the same time offered the market an opportunity to effect the same exchange with the Bank. Under the second type, the market was given an opportunity to purchase certain outstanding issues from the portfolio of the Bank in exchange for the newly-offered maturities. A feature common to both types of switching offer was that the market lengthened the average term to maturity of its holdings in the process. Most of these offers were taken up virtually to the full extent of their pre-announced limits.

The amount of treasury bills outstanding was increased by $370 million over the course of 1968; chartered bank holdings of bills increased by $403 million during the year. Apart from weekly changes in the tender, $150 million of one-year bills were sold in June, while a $100 million 11-day series in November provided the Government with temporary financing during the period of heavy redemptions of outstanding Canada Savings Bonds just prior to receipt of the proceeds of sale of the new Canada Savings Bonds in the autumn campaign. In addition $75 million of one-year bills were auctioned at the end of November to refund part of the $125 million of maturing one-year bills.

The first Canada Savings Bond issue in 1968 was the Special Replacement Series offered in March in advance refunding of the unusually large maturity of the 1959 Series due November 1; the refunding issue yielded 6.88 per cent if held to maturity in 1978. This campaign lasted until May 15 by which time $538 million of the 1959 Series bonds had been exchanged for the new issue. A further $312 million of the Special Replacement Series bonds were sold in a limited cash offering which followed the refunding campaign and terminated on May 23. The usual autumn Canada Savings Bond campaign took place against a background of great uncertainty as to the direction of interest rates. On this issue the yield was 6.75 per cent if held to maturity in 1982; if the interest coupons were held uncashed to maturity $250 would be received at that date for each $100 bond presented, as a result of the compounding of interest earned. The campaign was successful in netting almost $900 million during the October-November period.

FINANCIAL TRANSACTIONS OF CANADIANS WITH NON-RESIDENTS. As mentioned earlier (page 33), the increasingly large errors and omissions in the Canadian balance of payments statistics in 1967 and 1968 make interpretation of both the current and capital account flows difficult. In the official estimates, which attribute all of the balancing item to the short-term capital account, the net use of non-resident savings by Canadians is shown as declining from $543 million in 1967 to $181 million in 1968; net capital inflows in 1968 are shown at $534 million, slightly less than the $561 million inflow in 1967. Official reserves, which had risen by $18 million in 1967, increased by a further $353 million in 1968, of which $266 million was attributable to new foreign currency bond issues sold by the Government of Canada.

The recorded statistics indicate that net sales of securities to non-residents in 1968 were very much larger than in 1967. The table on page 47 shows that Government of Canada new bond issues and treasury bills sold abroad in 1968 exceeded by $261 million the small retirements of maturing Government bonds and Canadian purchases of outstanding Government bonds from non-residents. This was in contrast with the preceding two years when the Government repatriated considerable amounts of its foreign debt. Net sales of provincial and municipal bonds to non-residents rose slightly in total in 1968; sales of corporate bonds and stocks rose appreciably. From 1962 to mid-1967 non-residents had been reducing their holdings of Canadian stocks but for the past year and a half they have been adding to their holdings. The large inflows of capital from

NET SALES OF SECURITIES TO NON-RESIDENTS

(millions of Canadian dollars)

	1966	1967	1968
Canadian securities:			
Bonds — gross new issues	1,408	1,255	1,889
— retirements	− 495	− 338	− 394
— trade in outstandings	− 104	− 56	− 70
Total	809	861	1,425
Treasury bills and short-term paper	− 19	− 39	− 98
Corporate stocks	− 83	57	183
Total Canadian securities	707	879	1,510
Foreign securities:			
IBRD bonds — transactions by Government of Canada	− 25	− 20	45
Other foreign securities transactions	− 376	− 398	− 509
Total foreign securities	− 401	− 418	− 464
Total	306	461	1,046

sales of Canadian securities to non-residents have been offset in part by Canadian purchases of foreign securities, mainly United States corporate stocks; these rose again in 1968.

Almost all of the increase in 1968 in net sales of securities to non-residents resulted from sharply increased sales of new issues of Canadian bonds. Deliveries rose from $1,255 million in 1967 to $1,889 million in 1968. Of the total increase, $266 million arose from Government of Canada borrowings in Europe and the United States. At the close of 1967 Canadian borrowers were beginning to tap the developing European market by selling U.S. dollar bonds in the Euro-bond market, and in 1968 sales of such issues amounted to over $100 million. Following the sale of bonds in the German market by the Government of Canada in May, other Canadian borrowers placed issues in that market and by year-end they had sold the equivalent of about $220 million in bonds denominated in deutsche marks. As the table below shows, there was only a small increase in the total of funds raised by borrowers other than the Government of Canada in the United States market; such deliveries totalled $1,257 million in 1968 compared with $1,196 million in 1967.

Foreign direct investment in Canada is estimated to have amounted to $585 million in 1968 compared with $620 million in 1967. All of the reduction occurred in the first quarter when such investment dropped to almost nothing; it rose sharply in the second quarter and remained high in the second half of the year. Canadian direct investment abroad also varied with the swings in sentiment about the Canadian dollar in the first half of the year; for the year as a whole it was $170 million as compared with $90 million in 1967.

GROSS NEW ISSUES OF CANADIAN BONDS SOLD TO NON-RESIDENTS[1]

(millions of Canadian dollars)

	To United States residents			To other non-residents			Total
	Gov't of Canada	Other borrowers	Total	Gov't of Canada	Other borrowers	Total	
1967 — 1Q	–	295	295	3	8	11	306
2Q	1	273	274	3	6	9	283
3Q	–	259	259	4	4	8	267
4Q	3	369	372	6	21	27	399
Total	4	1,196	1,200	16	39	55	1,255
1968 — 1Q	–	340	340	4	63	67	407
2Q	76	356	432	179	91	270	702
3Q	–	279	279	4	177	181	460
4Q	16	282	298	9	13	22	320
Total	92	1,257	1,349	196	344	540	1,889

(1) Includes small amounts of bonds payable in Canadian dollars sold to non-residents.

Capital outflows from recorded short-term capital transactions rose in 1968. Canadian holdings of bank balances and other short-term funds abroad increased again, producing a substantial capital outflow. There was a sharp reduction in non-resident holdings of Canadian finance company paper and an offsetting rise in their holdings of Canadian dollar bank deposits and treasury bills. The balancing item in the statistics of the international balance of payments, which is included in the residual short-term capital account but which may represent unidentified net current payments as well as unidentified capital outflows, was large in the fourth quarter of 1967 and in 1968.

The foreign currency transactions of the chartered banks produced a net outflow of $375 million in 1968, almost the same as the outflow in 1967. In 1968 the banks channelled $438 million to the United States, with $63 million

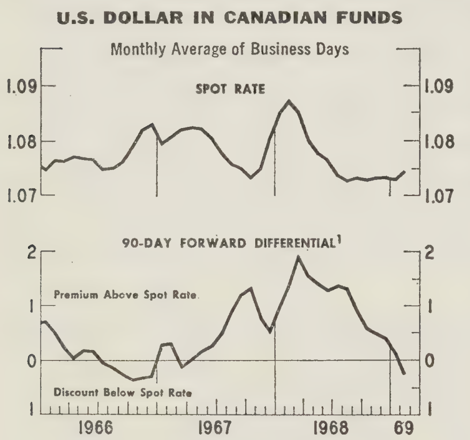
CANADIAN CHARTERED BANKS
HEAD OFFICES AND BRANCHES IN CANADA
NET CHANGES IN FOREIGN CURRENCY ASSETS AND LIABILITIES(1)

(millions of Canadian dollars)

	1966	1967	1968	Feb. to Dec. 1968
With non-residents				
United States residents				
Assets	229	264	137	317
Liabilities	−302	75	−302	−186
Net	532	189	438	503
Other non-residents				
Assets	2	330	624	492
Liabilities	63	153	687	685
Net	−61	177	−63	−193
Total				
Assets	232	594	761	809
Liabilities	−239	228	385	498
Net claims on non-residents	471	366	375	311
With Canadian residents				
Assets	91	−112	−54	−78
Liabilities	413	332	85	32
Net	−322	−444	−139	−109
Chartered banks' own net position	149	−78	236	202

(1) Does not include assets or liabilities in gold.

being raised in other countries and the remainder arising from transactions with Canadian residents and from increases in the banks' own foreign currency positions. In the spring of 1968 the banks agreed to observe three guidelines in the conduct of their foreign currency operations that would ensure that Canada was not used as a "pass-through" by which the purpose of the United States balance of payments programme would be frustrated. The text of these guidelines appears in the Appendix. On balance, the banks were net borrowers of funds from residents of overseas countries between the reference date for the guidelines of Feburary 29 and the end of the year. By the end of December their claims in overseas countries were $492 million higher than at the end of February but their liabilities were $685 million higher, so that their net liabilities in overseas countries rose by $193 million. In connection with the third guideline, from February to December they reduced their deposit liabilities to United States residents by $186 million.



1. Expressed as a per cent per annum.

The spot rate for the United States dollar in the Canadian foreign exchange market fluctuated close to the top of the permitted range from January to mid-March. It then declined steadily to late July when it reached the bottom of the permitted range, and it has subsequently fluctuated close to that level. The forward exchange rate for the U.S. dollar in Canada was at a large premium during most of the first half of 1968, declined gradually during the second half of the year, and moved to a discount in the opening months of 1969.

At the end of 1968 Canada's reserves were U.S. $2,848 million compared with U.S. $2,516 million a year earlier. Official holdings of gold and U.S. dollars rose by U.S. $559 million in 1968, while Canada's net creditor position with the International Monetary Fund declined by U.S. $227 million.

OFFICIAL HOLDINGS OF GOLD AND U.S. DOLLARS AND NET CREDITOR POSITION WITH THE INTERNATIONAL MONETARY FUND

(month-ends — millions of U.S. dollars)

	Dec. 1967	Mar. 1968	June 1968	Sept. 1968	Dec. 1968
Official holdings of gold and U.S. dollars...............	2,268	2,244	2,574	2,534	2,827
Net creditor position with IMF.........	248	–	–	1	21
Total..............................	2,516	2,244	2,574	2,535	2,848
of which:					
Repayable to IMF..................	–	185	64	–	–
Repayable to Federal Reserve System.................	–	250	125	–	–
Other...........................	2,516	1,809	2,385	2,535	2,848

APPENDIX TABLE I

BANK OF CANADA NET TRANSACTIONS IN GOVERNMENT OF CANADA SECURITIES IN 1968

(delivered basis — par value in millions of dollars)

	Net purchases from (+) or net sales to (−) investment dealers and banks						
		Bonds(1)					
	Treasury bills	3 years & under	3 years to 5	5 years to 10	Over 10 years	Sub-total bills and bonds	Securities under PRA
Jan.	−190	+ 45	− 4	− 45	− 11	−205	–
Feb.	− 51	–	–	–	–	− 51	–
Mar.	− 60	+ 2	–	–	–	− 58	–
Apr.	− 15	+133	−143	–	+ 2	− 23	–
May	–	+ 2	− 2	–	–	–	–
June	− 40	+ 82	–	−126	–	− 84	–
July	− 15	–	–	–	–	− 15	–
Aug.	−107	+121	− 71	− 26	− 24	−107	–
Sept.	+123	–	–	–	–	+123	–
Oct.	+ 17	− 1	–	− 13	+ 27	+ 30	–
Nov.	+ 36	–	–	–	+ 11	+ 47	–
Dec.	+ 60	–	–	–	–	+ 59	–
Total	−242	+384	−219	−211	+ 5	−283	–

(1) Classified by years to maturity at time of transaction.

Net transactions with Government and other client accounts								
Purchases (+) of new issues less matured holdings		Net purchases from (+) or net sales to (−)				Net change in holdings of Government of Canada securities		
		Securities investment acct.		Other Government and client accounts				
bills	bonds	bills	bonds	bills	bonds	bills	bonds	total
− 21	+ 57	–	− 50	− 49	−276	−260	−284	−544
+ 3	–	–	− 70	− 43	− 1	− 91	− 71	−162
+158	–	–	+120	− 84	− 4	+ 13	+118	+132
+ 21	+109	–	−100	+ 18	− 9	+ 24	− 7	+ 16
+ 67	− 20	–	–	− 29	− 3	+ 38	− 23	+ 15
+ 57	+132	–	–	− 46	+ 57	− 29	+145	+117
+ 11	–	–	–	− 31	+133	− 35	+133	+ 98
+ 69	+190	–	−100	− 41	+ 3	− 79	+ 93	+ 14
+104	–	–	–	− 45	− 2	+182	− 2	+180
− 12	+ 92	–	–	− 23	− 2	− 18	+103	+ 85
+ 42	–	–	–	− 53	− 1	+ 25	+ 10	+ 35
+143	+108	–	−100	− 59	− 3	+145	+ 5	+149
+643	+669	–	−300	−486	−108	−85	+220	+135

BANK OF CANADA ASSETS AND LIABILITIES

(monthly changes – millions of dollars)

	Government of Canada securities at book value	Net foreign currency assets	Investment in IDB	All other assets, net	Note circulation	Canadian dollar deposit liabilities		
						Chartered banks	Government of Canada	Other
1968								
Jan.	−542	+270	+ 2	+ 51	−186	−121	+ 92	−4
Feb.	−160	− 1	+ 2	− 15	− 30	− 43	−105	+4
Mar.	+130	+ 8	+ 1	− 38	+ 9	+ 38	+ 53	+1
Apr.	+ 16	+ 56	+13	+ 82	+ 59	+ 50	+ 63	−5
May	+ 15	+ 53	+ 1	− 55	+ 24	− 13	− 3	+6
June	+115	− 64	+ 2	+121	+106	− 43	+112	−1
July	+100	−184	+ 3	− 29	+ 73	+ 52	−233	−3
Aug.	+ 17	–	+ 1	− 8	− 44	− 42	+ 95	–
Sept.	+179	−129	–	+ 31	− 23	+151	− 50	+4
Oct.	+ 85	–	+ 8	−135	+ 20	− 96	+ 39	−6
Nov.	+ 34	–	+ 2	− 62	+ 37	+ 9	− 75	+2
Dec.	+148	+ 3	+ 4	+179	+204	+111	+ 17	+2
Total	+137	+ 12	+39	+121	+250	+ 52	+ 5	–

APPENDIX TABLE III

GOVERNMENT OF CANADA FINANCIAL ACCOUNTS

(millions of dollars)

	Calendar 1966	Calendar 1967	Calendar 1968
1. Budgetary deficit	428	678	733
Adjustments to national accounts basis:			
Amount financed by increase (—) in liabilities to:			
Public service superannuation accounts	—412	—432	—510e
Unemployment insurance and old age security funds	—289	—119	— 95e
All other adjustments to national accounts basis	109	129	157e
2. Deficit or surplus (—) on national accounts basis	—164	256	285e
3. Increase in major loans and advances to:			
Central Mortgage and Housing Corporation	456	678	394
Farm Credit Corporation	167	168	131
CNR (incl. Air Canada, excl. debt refunding)	17	124	130
Export Credits Insurance Corporation	38	28	42
Municipal Development and Loan Fund	122	66	7
Veterans' Land Act Fund	51	60	51
1967 World Exhibition	115	68	— 9
National governments	7	— 13	61
Provincial governments (excl. 1967 World Exhibition)	24	10	61
Other	58	46	46
Sub-total	1,055	1,235	914
4. Canadian dollars required to finance increase in Government's foreign currency assets (or reduction in liabilities):			
Advances to the Exchange Fund	—633	147	529
Holdings of IBRD and Columbia River Treaty bonds	— 7	— 12	— 78
Subscriptions and advances to international agencies	226	19	30
Foreign-pay securities (outside Gov't accounts)	164	45	—266
Demand notes payable to international agencies	—106	2	—229
Sub-total	—356	201	— 14
5. Net increase in other assets or reduction in other liabilities(1):			
Refundable corporation tax	—134	—106	82
Accrued corporation income tax(2)	— 31	—175	— 80e
All other assets and liabilities	—117	—135	—138
Sub-total	—282	—416	—136
6. Total Canadian dollar financing requirements (sum of items 2, 3, 4, 5)	253	1,276	1,049
7. Total Canadian dollar financing requirements were met by:			
Increase (+) in Canadian dollar securities outstanding outside Government accounts	303	978	1,109
Reduction (+) in Canadian dollar cash balances	— 50	298	— 60
Total (= Item 6)	253	1,276	1,049

e: Estimate.

(1) Excluding those shown under Item 7.

(2) A contra amount is included in the item "All other adjustments to national accounts basis" above.

Appendix

EXCHANGE OF LETTERS BETWEEN THE HONOURABLE MITCHELL SHARP, MINISTER OF FINANCE, AND THE HONOURABLE HENRY FOWLER, SECRETARY OF THE TREASURY OF THE UNITED STATES, DATED MARCH 7, 1968, RELATING TO THE APPLICATION OF UNITED STATES BALANCE OF PAYMENTS MEASURES TO CANADA.

Letter from Mr. Fowler to Mr. Sharp

Dear Minister Sharp:

Unique financial relations between our two countries have been a mutual support to both and to the international monetary system. These relations have served the interests of both our countries without interfering with the domestic policies of either.

As was said some years ago when it was agreed that Canada should be exempt under the interest equalization tax: "For many years the capital markets of the two countries have been closely interconnected and United States exports of capital to Canada have financed a substantial portion of the current account deficit with the United States. This need continues."

At the same time this special financial interdependence was underscored by the undertaking of Canadian authorities that it would not be the desire or intention of Canada to increase her foreign exchange reserves through the proceeds of borrowings in the United States.

It was agreed that active consultations would continue to strengthen the close economic relations between the two countries and facilitate measures for making the maximum practicable contribution to economic expansion and the strength and stability of both countries.

In keeping with this practice we and our colleagues have had the benefit of regular consultations prior to and since the New Year's day announcement by President Johnson of the deterioration in 1967 of the United States balance of payments and the special program designed to bring the United States balance of payments to or close to equilibrium.

We have reviewed the new situation and the new program particularly because of some concern in financial markets over the potential effects of the program on Canada's financial position.

Our over-all financial arrangements have worked well and to our mutual advantage. Our special relationships in the financial field include:

—All commercial bank lending to Canada regardless of maturities is exempt from the IET. Such loans to Canadian borrowers have priority under the federal reserve guidelines.

—There are no restrictions on the amount of long term loans to Canadian borrowers which can be made by United States non-bank financial institutions. Such long term loans are exempt from the IET, from the direct investment program and from the federal reserve guidelines.

—Canadian subsidiaries of United States companies as well as all other Canadian companies can come to the United States capital market and borrow free of the interest equalization tax to finance their investments in Canada.

We agree that the time has now come to adapt these special relations in the financial field to our mutual advantage in handling the new United States direct investment and federal reserve programs as well as Canada's reserve management policies.

The cardinal element in the present financial relationships between the United States and Canada is the fact that to the extent capital outflows from the United States to Canada of a kind now covered by the United States balance of payments measures are insufficient to finance Canada's current account deficit, Canadian borrowers would exercise their existing rights to borrow more in United States capital markets. Therefore any decline in the level of particular capital outflows to Canada from the level of past years caused by new United States measures could be expected to lead to increased borrowings by Canadian entities in the United States capital market.

In the light of this situation and to make sure that the flow of funds from the United States to Canada is adequate, the United States will undertake to exempt Canada from all the United States balance of payments measures affecting capital flows that are administered by the Department of Commerce or the Federal Reserve System.

By these arrangements Canada's financial position is assured insofar as capital imports from the United States are concerned, and the United States balance of payments objectives and program as announced on January 1st would not be affected.

I am sure that you will agree that it is desirable that we should continue to keep the economic and financial relationships between the two countries and with the rest of the world under continuing review, and that we should examine the detailed operation of this agreement and its impact on the balance of payments of both countries in the joint Canada - United States Ministerial Economic Committee and through regular meetings of our officials.

I am satisfied that these arrangements will provide mutual support to our payments position and hence strengthen the international monetary system.

Sincerely yours,
Henry H. Fowler.

Letter from Mr. Sharp to Mr. Fowler

Dear Secretary Fowler:

I acknowledge receipt of your letter of today.

Canada has, as you are aware, a great interest in the strength and stability of the United States dollar and we have been deeply impressed by the steps you announced at the beginning of the year to reduce your balance of payments deficit. We have also been conscious of your desire to operate your program in a way which recognizes the special position of Canada.

I am of course very pleased that you have now reached the conclusion that you can, consistently with the objectives of your program, give further recognition to this special position by exempting Canada completely from your balance of payments program.

The unique position of Canada was reflected in the Interest Equalization Tax exemption and reserve target agreement reached in 1963. The Canadian government feels that the further steps you are now taking should be matched by further steps on the Canadian side. First to ensure that your balance of payments position is in no way impaired as a result of your action, I am informing you that it is our intention to take any steps necessary to ensure that the exemption from your program does not result in Canada's being used as a "pass-through" by which the purpose of your balance of payments program is frustrated.

It is also our intention to invest our entire holdings (apart from necessary working balances) of United States dollars in United States Government securities which do not constitute a liquid claim on the United States, with of course effective safeguards to our position should our reserve level require.

I agree that these arrangements are in the interests of both countries and in the general interest and that they provide further evidence of the close and mutually beneficial relationships between us.

Yours sincerely,
Mitchell Sharp.

EXCHANGE OF LETTERS BETWEEN THE HONOURABLE E. J. BENSON, MINISTER OF FINANCE, AND THE HONOURABLE HENRY FOWLER, SECRETARY OF THE TREASURY OF THE UNITED STATES, DATED DECEMBER 16, 1968, RELATING TO THE APPLICATION OF UNITED STATES BALANCE OF PAYMENTS MEASURES TO CANADA.

Letter from Mr. Fowler to Mr. Benson

Dear Minister Benson:

In completing the 1969 United States balance of payments program and while arranging for an orderly transition, I thought it would be useful to review the unique financial relationship which exists between our two countries. This was last described in the exchange of letters I had on March 7, 1968, with your predecessor, Mitchell Sharp. In my letter I noted: "Unique financial relations between our two countries have been a mutual support to both and to the international monetary system. These relations have served the interests of both our countries without interfering with the domestic policies of either." Events since March add a new endorsement to this judgment.

This unique relationship which our two countries share is a natural reflection of a common and peaceful border of some 5,500 miles. It reflects as well the importance of trade and capital and neighbors who move across this invisible boundary. Recognizing this interdependence, we have long since believed that it is not in the interest of either country to occasion destabilizing influences on our currencies which might inhibit the other country in the pursuit of its own economic objectives. To this end, our policies in this field have been to support our overall objectives to our mutual advantage.

This is the reason, notwithstanding the crisis then raging in the gold markets of the world and only shortly after the President's New Year's Day balance of payments measure, that in March we were able to exempt Canada from our balance of payments measures. This exemption and your reaction to it was indeed "mutual support." Canada was thus assured of access to our markets for a wide range of capital transactions, enabling Canada to continue its traditional method of financing its current account deficit with the United States and permitting financial institutions in both countries to operate flexibly.

This latest recognition of the interrelationship of our international payments is also the reason you have taken constructive actions to ensure that Canada is not used as a "pass-through" channel by which the purpose of the United States balance of payments program might be frustrated. Moreover, the policy under which you invest your foreign exchange holdings is to our mutual advantage.

This is also the reason that in the exchange of letters last March we reiterated the basic principle that it would not be Canada's intention to increase its foreign exchange reserves through borrowings in the United States. Implementation of this principle does not require that Canada's reserve level be limited to any particular figure. We are well aware of Canada's need for flexibility with respect to reserve levels in order to accommodate the adaptation of monetary policy to the changing needs of its domestic economy, seasonal factors and other influences of a temporary nature. This statement of objectives recognizes that under circumstances in which

an improvement in the payments position of the United States is essential to the strengthening of the world monetary system, it is in Canada's own interest to avoid hindering the achievement of this objective by unnecessary borrowing in the United States. In recent times capital markets in other countries have developed a capacity which has attracted borrowers from many countries. Canadian authorities have taken advantage of these expanding capital markets to raise funds in substantial quantities. These developments now offer Canada an alternative means of achieving an increase in its reserves whenever Canadian authorities believe this is desirable. In addition, Canada has given strong support to the arrangements for new Special Drawing Rights which, when activated, will offer a source of regular and automatic additions to international reserves. Both our countries, along with other nations, actively support the ratification of this new facility in the International Monetary Fund and the activation of these reserve assets as soon as possible.

In undertaking this review of our relationship, I have been very much aided by the knowledge and experience our respective governments have gained through the close consultations which form such an important part of this relationship. These consultations will, of course, continue to permit us to keep each other fully informed of our views regarding current financial developments.

The unique financial arrangements we have developed, expressed first with the joint statement of July 21, 1963 and brought up to date today, provide support to the payments positions of both countries and hence strengthen the international monetary system.

Sincerely yours,
Henry H. Fowler.

Letter from Mr. Benson to Mr. Fowler

Dear Secretary Fowler:

I welcome the review of financial relationships between Canada and the United States which you have provided in your letter of today's date.

As you have noted, the Canadian Government is keenly aware of the importance to Canada and to the world, as well as to the United States, of the strength of the United States dollar and, as a means to that end, of a continued improvement in the international payments position of the United States.

With this in mind, the Canadian Government has adopted policies to ensure that the exemption of Canada from the United States balance of payments programme would not endanger the success of that programme. In particular, we have taken steps to prevent Canada from becoming a "pass-through" channel for the flow of capital from the United States. We have also found various appropriate means of supporting the payments position of the United States. Thus the Canadian Government has invested its United States dollar reserves (in excess of working balances) in special non-marketable issues of the United States Treasury. It also turned to the expanding capital markets of Europe to find funds with which to rebuild Canada's foreign exchange reserves. In the course of this year substantial sums have been added to our reserves as a result of borrowings of the Government of Canada and

other Canadians outside the United States, and the investment of these sums has provided support to the payments position of the United States. We expect, as you note in your letter, that the implementation of the Special Drawing Rights scheme in the International Monetary Fund will provide an additional well-regulated source of new reserve assets.

I too have found very useful the close consultations which have come to form such an important aspect of the relationship between our two countries. I look forward to a continuation of them as a means of keeping each other fully informed of our views regarding current financial developments.

In the light of all these considerations I can reiterate to you that it is not an objective of Canadian policy to achieve permanent increases in our exchange reserves through unnecessary borrowing in the United States. I fully share the view expressed in your letter that the implementation of this principle does not require that Canada's reserve level be limited to any particular figure, and that our reserves may be expected to fluctuate to accommodate the adaptation of monetary policy to the changing needs of the domestic economy, seasonal influences, and other influences of a temporary nature.

Yours sincerely,
E. J. Benson,
Minister of Finance.

STATEMENT BY THE MINISTER OF FINANCE DATED MAY 3, 1968, ANNOUNCING GUIDELINES FOR THE CHARTERED BANKS.

The Honourable E. J. Benson, Minister of Finance and President of the Treasury Board, announced today that following discussions with the chartered banks which the Bank of Canada undertook pursuant to the exchange of letters of March 7, 1968 between the Secretary of the United States Treasury and the Minister of Finance, the chartered banks are now conducting their operations in foreign currencies in such a way as to accord with the understandings reached in that exchange.

It will be recalled that Canada was granted exemption from the U.S. balance of payments measures affecting capital flows which are administered by the Department of Commerce and the Federal Reserve Board, and that in his letter to Mr. Fowler Mr. Sharp said that Canada would ensure that this exemption would not result in Canada's being used as a "pass through" by which the purpose of the United States balance of payments program would be frustrated.

The understanding reached with the chartered banks is embodied in three guidelines, which are appended. They provide in effect that Canadian banks will not be a channel for outflows of funds from the United States which impair the balance of payments of the United States without improving Canada's external position. The guidelines place no restrictions on the flow of funds from the United States to Canada through Canadian banking channels.

The Minister expressed his appreciation to the chartered banks for their co-operation.

1. The total of a bank's foreign currency claims on residents of countries other than Canada and the United States should not rise above the level of the end of February 1968 unless the increase is accompanied by an equal increase in its total foreign currency liabilities to residents of countries other than Canada and the United States.
2. If there should be a decline in the total of a bank's foreign currency liabilities to residents of countries other than Canada and the United States from the level at the end of February 1968 the bank should achieve an equal reduction in its total foreign currency claims on residents of countries other than Canada and the United States as quickly as the liquidity of such assets will permit.
3. Each bank should allow an increase in its U.S. dollar liabilities to residents of the United States from the level at the end of February 1968 only to the extent that the increase is fully matched by the sum of (1) the increase from that date in the bank's U.S. dollar claims on residents of Canada, (2) the decrease from that date in the bank's U.S. dollar liabilities to residents of Canada, and (3) the decrease from that date in the bank's own spot position in U.S. dollars.

STATEMENT BY THE MINISTER OF FINANCE DATED JULY 24, 1968, ANNOUNCING GUIDELINES FOR FINANCIAL INSTITUTIONS OTHER THAN BANKS.

The Honourable E. J. Benson, Minister of Finance, today recalled that in an exchange of letters on March 7, 1968, between the Secretary of the United States Treasury and the Minister of Finance, Canada was granted exemption from the U.S. balance of payments measures affecting capital flows which are administered by the Department of Commerce or the Federal Reserve Board, and that Canada undertook to ensure that this exemption would not result in Canada being used as a "pass-through" by which the purpose of the United States balance of payments program would be frustrated.

Mr. Benson noted that on May 3, 1968, the chartered banks had accepted a guideline which was designed to keep the total of each bank's foreign currency claims on residents of countries other than the U.S. and Canada from rising above the level of the end of February, 1968, unless the increase is accompanied by an equal increase in its total foreign currency liabilities to residents of countries other than Canada and the U.S.

Today he asked that a similar guideline be accepted by all other financial institutions operating in Canada, including trust companies, mortgage loan companies, sales finance companies, mutual funds, pension funds, insurance companies, investment companies, investment dealers, and small loan companies. The Minister asked that each of these financial institutions manage its affairs in such a way that the total of its foreign currency claims on residents of countries other than Canada and the United States, in the form of deposits, loans and portfolio investments in bonds and stocks, does not rise above the present level unless the increase is accompanied by

an equal increase in its total foreign currency liabilities to residents of countries other than Canada and the United States, or arises from net earnings of foreign branches or subsidiaries.

The Minister said that his officials will be getting in touch with Canadian financial institutions either directly or through their associations to ask them to improve the information available to him on their foreign currency assets and liabilities.

In addition, Mr. Benson requested all Canadian investors to continue to comply with the request made in March, 1966 by the then Minister of Finance, the Honourable Mitchell Sharp, to all Canadian investors, including all financial institutions, not to acquire securities denominated in Canadian or United States dollars which are issued by United States corporations or their non-Canadian subsidiaries and which are subject to the United States interest equalization tax if purchased by United States residents. Investments in such securities made by Canadian financial institutions in order to cover foreign currency liabilities to non-residents of Canada and the United States were exempt from this request. All Canadian financial intermediaries are asked not to facilitate transactions which would be contrary to this guideline concerning such "off-shore" securities.

The Minister expressed confidence that Canadians would co-operate in protecting the national interest by following these guidelines. If there are cases in which financial institutions find that the conduct of their operations in accordance with these guidelines gives rise to special difficulties he asked that the institutions take these up with his officials. In particular he would be prepared to consider approval of investments in countries outside Canada and the United States to meet essential legal or customary requirements for cover for foreign currency liabilities in such countries, if this cover cannot otherwise be provided.

STATEMENT BY THE MINISTER OF TRADE AND COMMERCE DATED SEPTEMBER 19, 1968, ANNOUNCING GUIDELINES FOR CANADIAN INCORPORATED COMPANIES, OTHER THAN FINANCIAL INSTITUTIONS.

The Honourable Jean-Luc Pepin, Minister of Trade and Commerce, today announced a program applicable to Canadian incorporated companies, other than financial institutions, which is designed to ensure that their investments outside of Canada and the United States will be compatible with Canada's unrestricted access to the United States capital market.

This action is being taken as a follow-up to the arrangements set out in the exchange of letters between the United States Secretary of the Treasury and the Canadian Minister of Finance, dated March 7th, 1968, providing for the exemption of Canada from the United States balance of payments measures affecting capital flows. As part of the arrangement Canada undertook to ensure that the exemption did not result in Canada being used as a "pass-through", by which the purposes of the United States program are frustrated. Guidelines to implement this undertaking with respect to operations of the chartered banks were announced by the Minister of Finance in May and guidelines for other financial institutions were announced in July.

The Minister emphasized that it is important that the flow of investment overseas should not be increased as a consequence of the unrestricted access of Canadian business to the United States capital market. In this connection the Minister noted that annual investment overseas by Canadian non-financial companies was normally modest in amount, and a continuation of a normal volume of Canadian investment of this kind would be in order. The Government is not proposing the establishment of quotas for individual non-financial companies in order to ensure that the aggregate flow of investment overseas from such companies is held to moderate dimensions but the Government is instead requesting that these companies adhere to certain priorities as indicated in the following guidelines:

> As regards investment in continental Western Europe, Canadian companies are asked not to embark on new investment programs or otherwise increase their assets in such countries in any way involving the transfer of capital funds or other forms of financing from Canada or the United States except in cases where firm commitments have been made or where it can be clearly demonstrated that such investment could be expected to bring unusually large and early benefits to Canada's trade and payments position and cannot be adequately financed from overseas sources.
>
> As regards investment in other developed countries overseas, companies are asked to exercise restraint in embarking on new investment undertakings which involve capital transfers or other forms of financing from Canada or the United States and to give priority to investment which will contribute importantly to improvement in Canada's trade and payments.
>
> The general restraint to be exercised with respect to capital transfers to overseas countries is not intended to inhibit desirable investment in less developed countries.
>
> Nothing in these guidelines is to restrict the financing of Canadian exports.

As part of the program Canadian incorporated companies are being asked to provide information quarterly on international capital transfers actually made, and also to provide information on planned capital transfers to overseas countries for 1968 and 1969 in cases where transfers in excess of $200,000 annually are contemplated. The forward plans submitted will be carefully reviewed in light of the need to keep total Canadian investment overseas within moderate dimensions consistent with the exemption from the United States balance of payments restrictions. Particular attention will be given to programs which involve the use of funds obtained from the United States either directly or indirectly.

STATEMENT BY THE HONOURABLE MITCHELL SHARP, MINISTER OF FINANCE, TO THE HOUSE OF COMMONS, MARCH 16, 1966.

When the United States balance of payments guidelines were being discussed in this house on February 2, I said that it would be most undesirable if the effect of these guidelines was to induce strong new demands upon capital markets in Canada. I also indicated that if necessary we would take whatever action is appropriate to protect Canadian interests. Prior to our meeting with United States Secretaries in

Washington it seemed clear that pressures on our capital markets were being accentuated as an indirect result of the United States guidelines, and we discussed this with them.

Under the guidelines, United States companies are being encouraged to raise funds abroad for their international operations. In response to this, well known United States companies and their foreign subsidiaries are issuing dollar securities for sale outside the United States. To the extent that this search for funds abroad by United States companies attracts funds from Canada, it puts abnormal pressure on the Canadian market and could force Canadian borrowers to rely more heavily on the United States capital market.

It has been, and continues to be, the policy of the government to encourage Canadians to invest their savings in Canadian development. We are now entering our sixth consecutive year of significant economic growth. Heavy demands are being made on our capital markets as Canadian industry expands its capacity and improves its efficiency and as Canadian governments and municipalities undertake to provide the many services required by our expanding economy.

To meet this situation I am, on behalf of the government, making the following request today to Canadian investors.

To help ensure that Canadian savings are available to meet the present large demands for capital in Canada the government is asking all Canadian investors, including financial institutions such as the banks, life insurance companies, and trust and loan companies, as well as other corporations, pension funds and individuals, not to acquire securities, denominated in Canadian or United States dollars, which are issued by United States corporations or their non-Canadian subsidiaries and which are subject to the United States interest equalization tax if purchased by United States residents. Investments in such securities made by Canadian financial institutions and pension funds to cover foreign currency liabilities to non-residents of Canada and the United States are exempt from this request.

Canadian borrowers have co-operated with the government's requests in the past for the exercise of some temporary restraint in borrowing abroad in the national interest. I feel certain that Canadian investors on their side will co-operate fully with this request which is also in the national interest.

For some time the Bank of Canada and the Department of Finance have, in answer to enquiries, been discouraging the issue of securities in Canada by foreign borrowers. I feel that we should continue to discourage such issues since the use of Canadian savings in this way could bring increased pressures on our capital market and lead to increased borrowings in the United States by Canadians under the exemption from the interest equalization tax. I am confident that our financial institutions will continue to assist us in carrying out this policy.

BANK OF CANADA STATEMENT OF INCOME AND EXPENSES

(thousands of dollars)

	1968	1967
Income		
On investments (including deposits)	$203,323	$193,240
All other income	179	204
Total income	$203,502	$193,444
Operating Expenses		
Salaries(1)	$ 6,257	$ 5,658
Contributions to pension and insurance funds	542	501
Other staff expenses(2)	467	349
Directors' fees	30	28
Auditors' fees and expenses	85	83
Taxes (municipal and business)	1,306	1,248
RCMP guards and electric protection	225	175
Insurance	67	60
Bank notes — production and shipment	4,887	5,591
Data processing and computer costs	344	257
Other equipment and premises (net)	706	371
Printing of publications	107	117
Other printing and stationery	292	219
Postage and express	259	241
Telephones and telegrams	219	189
Travel and transfer expense	206	184
Interest paid on unclaimed balances	68	59
All other expenses	282	242
Total operating expenses	$ 16,349	$ 15,572
Depreciation on Buildings and Equipment	998	848
Net Income Paid to Receiver General of Canada	186,155	177,024
	$203,502	$193,444

(1) The number of staff averaged 1,045 in 1968 and 1,002 in 1967
(2) Includes overtime pay, medical services and cafeteria expense.

BANK OF CANADA • STATEM

ASSETS

	1968	1967
Deposits payable in foreign currencies		
Pounds sterling and U.S.A. dollars	$ 95,765,052	$ 90,641,089
Other currencies	156,521	251,509
	95,921,573	90,892,598
Cheques on other banks	152,236,827	105,583,628
Advances to chartered and savings banks	5,000,000	3,000,000
Accrued interest on investments	50,940,327	46,473,690
Investments — at amortized values		
Treasury bills of Canada	453,368,678	538,304,355
Other securities issued or guaranteed by Canada maturing within three years	1,540,915,405	1,269,681,384
Other securities issued or guaranteed by Canada not maturing within three years	1,890,338,307	1,940,122,952
Debentures issued by Industrial Development Bank — Note	305,041,830	270,231,238
Securities issued by the United Kingdom and the United States of America	10,752,213	10,710,303
	4,200,416,433	4,029,050,232
Industrial Development Bank		
Total issued share capital at cost — Note	49,000,000	45,000,000
Bank premises		
Land, buildings and equipment Cost less accumulated depreciation	22,150,087	17,348,143
Net balance of Government of Canada collections and payments in process of settlement	58,183,461	72,995,671
Other assets	1,716,238	1,280,080
	$4,635,564,946	$4,411,624,042

Note: The audited financial statements of the Industrial Development Bank as at September 30, 1968 were issued to the public on December 9, 1968.

L. RASMINSKY, Governor
Ottawa, January 28, 1969

A. J. NORTON, Chief Accountant

ASSETS AND LIABILITIES

AS AT DECEMBER 31, 1968
(with comparative figures as at December 31, 1967)

LIABILITIES

	1968	1967
Capital paid up	$ 5,000,000	$ 5,000,000
Rest fund	25,000,000	25,000,000
Notes in circulation	3,229,211,295	2,978,939,617
Deposits		
Government of Canada	47,447,900	42,171,527
Chartered banks	1,114,326,553	1,062,017,745
Other	38,380,403	37,925,605
	1,200,154,856	1,142,114,877
Liabilities payable in foreign currencies		
To Government of Canada	26,983,626	32,367,592
To others	1,301,224	2,450,753
	28,284,850	34,818,345
Bank of Canada cheques outstanding	146,459,854	224,406,917
Other liabilities	1,454,091	1,344,286
	$4,635,564,946	$4,411,624,042

Auditors' Report • We have examined the statement of assets and liabilities of the Bank of Canada as at December 31, 1968. Our examination included a general review of the accounting procedures and such tests of accounting records and other supporting evidence as we considered necessary in the circumstances. In our opinion, the accompanying statement of assets and liabilities presents fairly the financial position of the Bank as at December 31, 1968.

JACQUES RENÉ DE COTRET, C.A.
of René de Cotret & Cie.

T. C. KINNEAR, F.C.A.
of Price Waterhouse & Co.

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* Appointed February 1969

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BANK OF CANADA

ANNUAL REPORT OF THE GOVERNOR TO THE MINISTER OF FINANCE

AND STATEMENT OF ACCOUNTS

FOR THE YEAR 1969

BANK OF CANADA *Ottawa 4*

February 28th, 1970.

The Hon. E. J. Benson, P.C.,
Minister of Finance,
Ottawa, Ontario.

Dear Sir,

In accordance with the provisions of the Bank of Canada Act I am transmitting herewith my report for the year 1969 and a statement of the Bank's accounts for this period which is signed and certified in the manner prescribed in the by-laws of the Bank.

Yours very truly,

L. Rasminsky

Governor

BANK OF CANADA

Report of the Governor — 1969

Some Highlights of the Year

The past year was one of both strain and progress in the world economy. The major industrial countries virtually all experienced strong inflationary pressures which threatened the continuation of the long period of expansion. There was, however, reason for encouragement in the action taken by the authorities of many countries, including the United States, to change the inflationary environment by checking excessive demand pressures. Another hopeful development was that the international currency system, which had been beset by a number of crises in the past few years, was a good deal more stable at the end of 1969 and a considerable degree of confidence had been restored.

While economic activity in Canada continued to expand for the ninth successive year, the over-all performance of the economy in 1969 cannot be regarded as satisfactory; prices continued to rise at an unacceptable rate, and public policy, including monetary policy, had to be vigorously directed to restraining the inflationary pressures.

After so long a period of expansion and after several years of significant price rise, the expectation of continued price increases had come to be firmly embedded in the thinking of many important elements of the community and the response to the policies of restraint was slow. However, by the latter part of 1969 there were signs of a slowing down in the rate of expansion, though there is not as yet convincing evidence of moderation in the rate of price and cost increase.

The slowing down in the rate of expansion in Canada and the development of a greater degree of slack does not become apparent if one looks merely at the annual changes in output and unemployment. Indeed, the increase in real output in 1969—nearly 5 per cent—was about the same as in 1968. Unemployment in 1969 averaged 4.7 per cent, slightly less than in 1968 and in January 1970 it was 4.5 per cent, seasonally adjusted. But the labour force has grown at an abnormally low rate since the first quarter of 1969; and the higher average level of output in the year as a whole owed a great deal to a continuation into the first quarter of 1969 of a particularly strong period of expansion. For the balance of the year the underlying trend—if one looks through the distorting effects of the important strikes that occurred—was that expansion was proceeding at a distinctly lower rate.

For five years now, the Consumer Price Index has been rising at a rate in excess of 3 per cent a year and for the past two years at rates of 4 per cent to 4½ per cent. The need for stringent monetary policies to help contain and combat this erosion in the purchasing power of money has been widely accepted in Canada, mainly, I believe, because of a growing appreciation, based on concrete experience, of the dangers of inflation. There are, to be sure, some differences of opinion in the approach to economic policy, but it would be a mistake to believe that these differences reflect different basic attitudes towards fundamental aims. In particular, there is not, as is sometimes alleged, one group who care about people and their employment and another group who care only about price stability. This is a false antithesis. Everyone wants to achieve increases in output, employment and standards of living that are as great as can be managed. The differences of opinion reflect, in large measure, differences in time perspective. Some concentrate their attention on the short-run costs of anti-inflationary policies. On the other hand, those who stress as I do the importance of price stability believe that we shall have a better chance of maintaining a high rate of growth of employment in the future if care is taken to preserve the purchasing power of money. More than this, they feel as I do that there is no justification for risking the serious injury to our economy and our society which would occur if measures of restraint were insufficient and inflation were permitted to accelerate.

Some slowing down of the economy was indeed, in the circumstances, a necessary prelude to a reduction of price and cost pressures. The purpose of restraint is not, however, to slow down the economy for its own sake but as a means of slowing down the price and cost increase in order to provide a solid base for sustainable economic expansion. Policy will not achieve its objective if it is abandoned at the first sign of success, namely, as soon as the growth of the economy shows signs of deceleration. This is particularly the case if there are widely held inflationary expectations.

The public authorities must, of course, always be mindful of the danger of pushing restraint beyond the point necessary to do the job of dealing with the inflationary situation. There are lags in the effect of policies of restraint on total spending in the economy and of changes in total spending on costs and prices which must be kept in mind. So far as the central bank is concerned, there is no escape from the difficult judgments which must continuously be made: it must be constantly appraising all the information which is becoming available and must balance the risk of going too far and contributing to an undesirable degree of slack in the economy against the risk of premature or excessive relaxation which would trigger off fresh inflationary expectations and actions.

The results up to the present of the policies followed during the past year make it reasonable to hope that continued efforts to control inflation will begin to yield their fruit and permit us to return to sustained non-inflationary growth. There has been an encouraging change in the economic climate. Meanwhile, a

widespread understanding of the problem continues to be necessary, and because of this I comment in some detail in the immediately following pages of my Report on the way in which anti-inflationary policies can be expected to work, on some of the particular problems of conducting such policies in Canada, and on the reasons why, in my opinion, we have no choice but to continue the effort in spite of all the difficulties involved. This is followed by a review of the main developments in monetary policy during the past year; the first part of the Report concludes with some general observations on recent international financial developments.

THE PROBLEM OF INFLATION

Throughout the past year the policy of the Bank has been directed towards achieving and maintaining tight credit conditions in order to help bring inflationary pressures in the economy under control. The thrust of fiscal policy has been in the same direction. For the most part, monetary and fiscal policies operate through market forces. The slowing down of the growth of total spending which these policies produce causes markets for goods and services to soften, and it becomes difficult for businessmen to raise prices. A squeeze on profits develops and businesses eventually have no alternative but to resist cost increases, including increases in wages and salaries which go much beyond the increase in productivity. (The crucial role played by wages and salaries in the price increases of recent years is shown in the table on page 32.)

Policies of financial restraint do not eliminate inflation very rapidly, particularly if price and cost increases have developed a good deal of momentum. Moreover, they are not without real costs in terms of a temporary loss of employment and output. Unless we are prepared to accept widespread direct governmental intervention, there is really no choice but to place major reliance on monetary and fiscal policies if we seriously wish to control inflation and avoid major damage to the economy. Naturally, it would be better if inflation could be dealt with by increasing the supply of goods and services rather than by restricting demand. "Supply" policies designed to increase the efficiency and mobility of our resources (such, for example, as retraining and the development of labour skills) are indeed of fundamental importance to the long-run performance of the economy, and much emphasis has properly been placed on them by governments. But such policies cannot unfortunately be expected to make an important contribution to the present urgent problem of controlling inflation.

There are time lags which delay the impact of policies to restrain spending. I shall refer in the next section to some of the lags involved in the effect of changes in monetary policy on the availability of credit. Even when monetary restraint is fully effective and conditions in financial markets become tight, individuals and businesses do not react immediately by moderating their spending

Third, inflation militates against economic growth. It introduces an additional element of uncertainty about the future which diverts people's energies and skills away from constructive activities towards trying to out-guess the course of the inflation. It rewards economic initiatives on the basis of how well they happen to fit the progress of the inflation rather than on their economic contribution. Such temporary stimulating effects as inflation can have on the level of economic activity depend on it not being expected: if inflation is pushed to the point where it is generally expected and constant efforts are being made to adjust to it, then the stimulating effects are lost.

Fourth, inflation is extremely damaging to capital markets. The less confidence there is in the maintenance of the value of money, the more reluctant investors are to commit their funds for long periods of time. Economic growth cannot fail to be retarded if it becomes extremely difficult to borrow long-term funds for projects that take many years to yield their full return. It is true that some borrowers, notably business corporations, can continue to obtain a portion of the funds they require by giving up equity in some form or other, for example, through convertible debentures. But this is not possible for homeowners or for provincial or municipal governments borrowing to provide social capital, including funds for schools, universities and hospitals.

Finally, inflation can undermine our international competitive position. It is true that other countries are also having a difficult time in controlling inflation, but we should not assume that they will fail to do so. And if we could make some gains in our competitive position by doing somewhat better than others in controlling inflation, the long-term rewards in the form of increased output and employment and an improved trade balance would be tangible and worthwhile.

For all of these reasons, it is really not open to us to abandon the effort to deal with inflation. The special characteristics of the Canadian economy do, however, require that we should constantly be seeking, in ways that include co-operative action between different levels of government, to make the impact of our policies as equitable and selective as we can. They also reinforce the general point I have made on a number of occasions that the over-all policies of fiscal and monetary restraint should, to the maximum extent possible, be supplemented by voluntary restraint in order to shorten the duration of such policies and thus minimize their temporary unwelcome side effects. Everyone would derive benefits from a concerted effort to break into the interrelated cost-price push of recent years. I strongly support the efforts of the Prices and Incomes Commission to achieve this objective.

MONETARY POLICY

Since the autumn of 1968, when it became clear that the anticipated moderation of inflationary pressures was not occurring, monetary policy has

again been directed towards restraint. The tightening of credit conditions has involved both higher costs for money and the restriction of credit availability.

The trend of interest rates in Canada in 1969 was greatly influenced by movements of rates abroad, and particularly by the direct and indirect effects of the extraordinary increases which occurred in the Euro-dollar market. The magnitude of these increases is illustrated in the next section of this Report. The Euro-dollar market is a very large international money market, and the very high rates paid in it exerted a powerful pull on funds and put strong upward pressure on short-term interest rates in all countries.

As interest rates rose in the first half of 1969 our Bank Rate was increased three times—from 6½ per cent to 7 per cent at the end of February, to 7½ per cent in June and to 8 per cent in July, where it has since remained. Commercial paper rates reached a peak of about 9½ per cent towards the end of the year; the average yield on long-term Government of Canada bonds reached a level of 8⅜ per cent; the prime conventional residential mortgage rate was about 10½ per cent. There was a moderate decline in security yields early in 1970, reflecting in part a larger downward movement in the United States and some relaxation in the Euro-dollar market.

The general restriction of the availability of credit lagged somewhat behind the increase in its cost, except in the case of new bond issues in Canada. A substantial decline in the amount of new money raised in Canada through the issue of long-term bonds took place in 1968 and there was a further decline in 1969. Part of this decline in domestic bond issues was offset by increased borrowing in foreign markets. In the mortgage market, the flow of funds was relatively well maintained until the second half of 1969. Bank loans continued to rise rapidly through the first part of 1969 but since the beginning of the summer the banks have felt the need to ration loans severely.

The restrictive monetary policy was slow in having a substantial impact on the availability of bank credit because at the beginning of the present period of severe restraint the banks were quite liquid and because under the pressure of the heavy loan demand which developed they turned out to be willing to see their liquidity run down to considerably lower levels than they had in the past. By April 1969 the combination of the restrictive policy of the central bank and the continued rapid expansion of bank loans had reduced the banks' ratio of more liquid assets to total assets below 29 per cent, a new low up to that time. On April 11 the Bank of Canada announced that it was raising the minimum secondary reserve ratio requirement from 7 per cent of deposit liabilities to 8 per cent, an action which had the effect of impounding about $250 million of the banks' liquid assets, thus making them unavailable to finance further loan expansion.

The Bank of Canada has continued to keep the cash and liquid positions of the banks under pressure in order to maintain tightness in the credit system. Between April 1969 and February 1970, the banks' more liquid assets were reduced substantially and the ratio to their total assets has moved down to around 25 per cent.

The effects of monetary policy on the banking system in 1969 show up clearly in the broad aggregates. A definite slowing in the rate of increase in bank loans occurred in May and June, and in the second half of 1969 the annual rate of increase in the aggregate of business and consumer loans was less than 4 per cent. Despite some upward movement in November and December, the total Canadian dollar assets of the banks grew at an annual rate of only 2 per cent in the second half of 1969—5 per cent for the whole of the year. The privately held money supply as broadly defined (i.e. the total amount of currency outside banks and Canadian dollar bank deposits held by the general public) rose by less than 4 per cent in 1969; the increase in money holdings would be somewhat greater if account were taken of the large rise in foreign currency deposits at the chartered banks.

The availability of credit through the banking system in 1969 was affected by the Bank of Canada not only through cash reserve management and the increase in the secondary reserve requirement but also by the Bank's request to the larger chartered banks that they compete less aggressively for large blocks of Canadian dollar short-term deposits. Large investors wishing to stay liquid look for temporary employment for their funds in bank deposits, short-term government securities, commercial and finance company paper and short-term claims on other financial institutions. In many cases the funds are in effect put up for auction, and the competition for them tends to be very intense as the major banks are very reluctant to lose accounts of large, established customers. In our system this has in some circumstances led to an undue escalation of interest rates paid on short-term deposit instruments, which in turn has tended to pull up the whole structure of rates.

In response to requests of the Bank of Canada, the larger banks have limited the rates paid on their short-term Canadian dollar certificates of deposit. Since last July the maximum rate has been 7½ per cent. As a result in part of the restraint exercised by the banks, their deposits in this category have declined considerably. It also seems likely that the rise in the short-term interest rate structure has been in some degree limited. The Bank of Canada is well aware of the problems involved in using moral suasion to influence the rates of interest paid by banks, since this affects the distribution of savings between various financial institutions and various types of instrument. However, the experience of recent years suggests that there are circumstances in which some such action is

necessary. I wish to acknowledge that the co-operation of the banks in this matter has been of considerable help in the implementation of monetary policy.

The decline in the short-term certificates of deposit just referred to was to some extent offset by a very rapid increase in foreign currency "swapped" deposits* with the chartered banks. The rates of interest available on such deposits were influenced by the upward spiral of short-term rates in the Euro-dollar market. In the middle of July, when the Bank Rate was raised to 8 per cent, the Bank of Canada requested the chartered banks to accept a temporary ceiling on "swapped" deposits. The purpose of this action was to limit the impact on the Canadian market of the extraordinarily high rates prevailing in the Euro-dollar market. In January 1970 the Bank asked a number of other financial institutions not to frustrate the effect of the ceiling on "swapped" deposits by arranging similar transactions in other ways.

The Bank of Canada has requested the co-operation of the chartered banks on a number of other matters. In order to soften the impact of tight credit conditions on less prosperous areas of the country, the Bank of Canada has asked them to have special regard for borrowers in those areas. The Bank has also asked the banks to pay particular attention to loan applications from small businesses throughout the country since, unlike large corporations, they do not normally have alternative sources of credit. The Bank has also expressed the view that the chartered banks should maintain a reasonable continuity of lending on housing mortgages. Finally, in view of the higher bank loan rates now prevailing in the United States, which give United States corporations an incentive to borrow here directly or through Canadian subsidiaries, chartered banks were asked to give priority in the use of their total loan resources to the credit-worthy demands of their Canadian customers.

INTERNATIONAL FINANCIAL DEVELOPMENTS

The past year has witnessed a number of remarkable developments in the international financial system. The one on which I shall comment first is the very sharp increase in interest rates in the Euro-dollar market. Others reflected encouraging progress in dealing with some of the problems that have beset the system in recent years.

Interest rates on term deposits in the Euro-dollar market rose from a level of a little above 7 per cent at the beginning of the year to a peak of over 12 per cent in June, and they averaged well above 10 per cent for the rest of the year. They dropped below 9½ per cent in the early months of 1970.

Although many factors affected the level of Euro-dollar rates in 1969, the principal one was massive borrowing in that market by the foreign branches of

* Funds converted into a foreign currency, usually U.S. dollars, which have been placed on term deposits with a bank and which the bank has undertaken through a forward contract to convert back into Canadian dollars at maturity.

United States banks on behalf of their head offices. This borrowing was induced by a tightening of monetary conditions in the United States, and the nature of United States banking arrangements was such that the borrowing continued even after Euro-dollar rates rose far above United States rates, thus producing an escalated upward movement in Euro-dollar rates. In the countries most exposed to the influence of Euro-dollar rates a rising trend in interest rates was in general appropriate to their domestic economic situations, but the rapidity and extent of the Euro-dollar increases was so great that many countries took special measures aimed at limiting the pull of the Euro-dollar market and moderating the impact on their rates of the high Euro-dollar rates. As already indicated, the Bank of Canada in July 1969 obtained the co-operation of the chartered banks in limiting outflows through "swapped" deposits.

Turning to the international exchange rate situation, one outstanding problem that was resolved was that of the foreign exchange value of the German mark. On September 29, 1969 the German authorities announced that they would no longer maintain the declared par value of the mark and, after allowing its exchange value to float for four weeks, they declared a new par value at a level approximately 9 per cent higher than the old parity.

A widespread opinion that the German mark would sooner or later be appreciated had been evident for at least a year before it happened. Among the factors which contributed to this view were the persistent strength in the current account of the German balance of international payments and indications that Germany would experience growing inflationary pressures if it did not revalue. Expectations regarding revaluation erupted in massive purchases of marks in November 1968 and in May and September 1969; and on each occasion great strains were placed on the payments positions of a number of other countries. It is estimated that the cumulative net inflow into Germany in anticipation of revaluation had reached the extraordinary level of some U.S. $5 billion at the end of September 1969. It now seems that the greater part of this vast inflow had been reversed by the end of the year. The return flow strengthened the foreign exchange positions of many countries, particularly the United States.

One benefit to the world of the period of substantial German payment surpluses was the emergence in Germany of a large international market for long-term capital. Since the revaluation the availability of new long-term German capital to foreign borrowers has been sharply reduced. In the longer run it will be helpful to other countries if Germany achieves a payments equilibrium which is consistent with being a substantial exporter of capital.

The foreign exchange value of the French franc gave rise to considerable uneasiness after the events of May and June 1968 had weakened the international payments position of France. There were widespread expectations that a depreciation of the French franc would accompany an eventual appreciation of

the German mark, and in these circumstances each surge of buying of marks gave rise to some selling of francs. The French authorities announced a reduction in the par value of the franc by approximately 11 per cent effective August 10, and followed this with a programme of fiscal and monetary measures designed to restore both internal and external equilibrium. Thereafter, and particularly since the revaluation of the German mark, France experienced a substantial return flow of funds and the franc has strengthened in foreign exchange markets.

The payments position of Britain continued to be a source of concern in the first part of 1969, as it had been for a number of years, and each outbreak of speculation on the German mark and the French franc put pressure on sterling. By late summer, however, it became evident that a significant improvement in Britain's payments position was under way, and subsequent developments have confirmed that trend. In the second half of 1969 Britain had a substantial overall surplus in its balance of payments, sterling strengthened on the exchanges, and the British authorities were able to make substantial repayments of the large short-term debt that they had incurred in recent years.

The long international discussions of plans to protect the world against a future shortage of international liquidity were brought to a successful conclusion in 1969. Members of the International Monetary Fund agreed to empower the Fund to create Special Drawing Rights, and approved the recommendation of the Fund's Managing Director to create and distribute 3.5 billion SDRs (having a value of U.S. $3.5 billion) on January 1, 1970 and a further 3 billion in 1971 and in 1972. In the perspective of history, I have little doubt that the decision to create SDRs will be regarded as the outstanding event of 1969 in the monetary field. In previous Reports I have expressed my strong support for the SDR plan, and I regard the first creation of SDRs as a great forward step in the evolution of the international monetary system.

The regular quinquennial review of the size of member countries' quotas provided for in the Articles of Agreement of the International Monetary Fund was successfully concluded late in 1969. It recommended an average increase in quotas of about one-third, and this recommendation has been approved. There is considerable variation around the average to take account of the different rates of growth of member countries since the last revision. The increases will become effective late in 1970 for Fund members who agree to them. The increase approved for Canada is from U.S. $740 million to U.S. $1,100 million, an increase somewhat greater than the average. The increase in quotas will enable the Fund to meet the growing needs of an expanding world economy for conditional credit. The increase in the Canadian quota will allow us to provide more balance of payments assistance to other countries through the Fund when our payments position is strong, and to receive more assistance from others should we have need of it.

One indication that confidence in the structure of foreign exchange rates had been restored by the end of 1969 was the decline in the price of gold in the private market. For most of the time from the establishment of the two-tier market for gold in March 1968 until late in 1969 the price of gold in the private market was above U.S. $40 per ounce. After rising to a peak of close to $44 in March 1969, it fell rapidly from $40 late in October 1969 to touch $35 early in December and has since fluctuated in a narrow range around $35. At the end of December the International Monetary Fund announced that agreement had been reached providing for the purchase under certain conditions of newly-mined gold from South Africa at $35 per ounce. This terminated a long period of uncertainty, and the Fund has since bought South African gold. The current tendency of the world's stocks of monetary gold to rise is in sharp contrast to the heavy outflows from those stocks in the period preceding the introduction of the two-tier gold market.

The experience of recent years has given rise to frequent suggestions that the world economy could be strengthened by altering the Fund's arrangements for determining countries' exchange rates in a way that would encourage more flexibility in rates, and a number of means of doing this have been proposed. The Fund is now engaged in a thorough study of these proposals and a report on its conclusions is expected this year. I have noted with interest an increasing awareness that a good deal of the rigidity in exchange rates that has attracted critical comment is not due to the nature of the Fund system or to Fund policy, but to the reluctance of governments to change their parities. One consequence of the recognition of this fact is an increasing tendency to focus on the question of national policies, a tendency which I welcome for I believe that it is primarily to better national policies rather than to changes in the exchange rate system that we must look to achieve and maintain a satisfactory operation of the international financial system.

I record with pleasure that on January 2, 1970, the Bank of Canada became a member of the Bank for International Settlements by subscribing to shares of BIS capital stock. Meetings of the BIS bring together regularly senior officers of most of the world's larger central banks, and have made the BIS an important centre for international monetary collaboration. The Bank of Canada has frequently taken advantage in recent years of a standing invitation from the BIS that we be represented at its meetings, and we have found both these contacts and our operating relationships with the BIS to be very helpful. Bank of Canada membership in the BIS will thus confirm and continue a valuable external association.

The International Environment

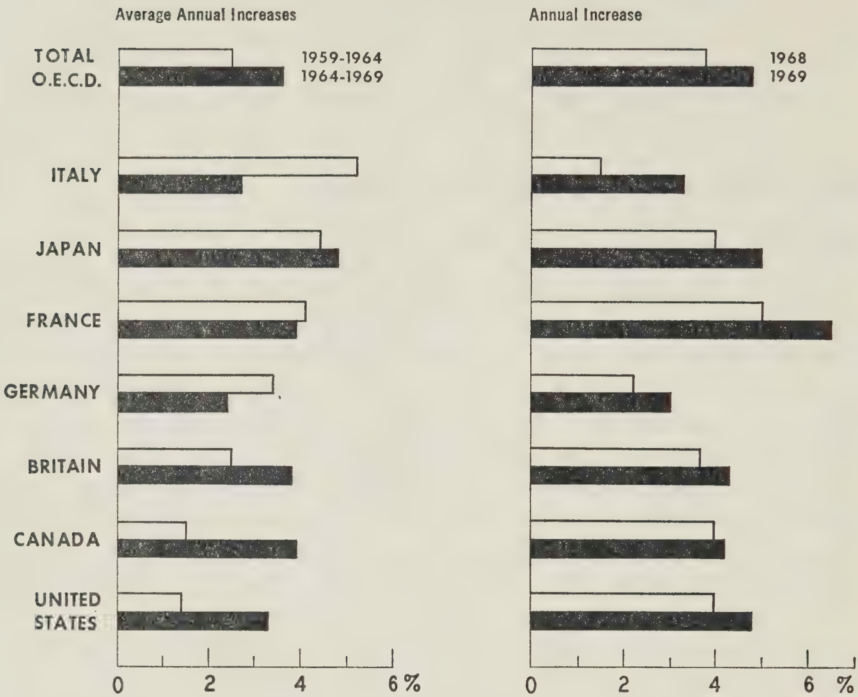
ECONOMIC AND FINANCIAL DEVELOPMENTS

Despite the slowing of economic expansion in the United States, the rate of growth in world output was well maintained in 1969; production in the industrial countries rose by approximately 5 per cent, slightly less than in 1968 but about in line with the average for the past ten years. Measures to restrain demand resulted in a very moderate rate of expansion in Britain and in a progressive slowing of the growth of the United States economy. In the latter country the increase in real output, which had been as much as 6½ per cent annually during the first half of 1968, dropped to only 2¼ per cent annually in the first half of 1969 and came to a halt in the final quarter. Nevertheless, the labour market in the United States remained tight. For the year as a whole the unemployment rate averaged 3½ per cent, as low as in 1968 and lower than at any other time since the Korean War. Late in the year, however, it was tending to move up and was at a seasonally adjusted rate of 3.9 per cent in January 1970. There were substantial increases in output in Japan, Germany and most continental European countries and the pace of activity brought increasing pressure on plant capacity and labour markets. Expenditures on plant and equipment continued to rise strongly in practically all industrial countries, reflecting both the very high levels of demand and the incentive to offset rising labour costs by more capital-intensive methods of production.

Wage rates rose sharply in most countries. In North America continued large increases in wages and salaries together with slower growth in output resulted in an acceleration in the rise in unit labour costs and a squeeze on profits. In continental Europe, wage settlements have been larger than in North America; particularly dramatic increases occurred in France in 1968, in Germany during 1969 and in Italy in recent months. Even though the growth in productivity has continued, unit labour costs have risen appreciably in most European countries. Recently there also has been some tendency for unit labour costs to rise in Japan. Widespread increases in industrial material prices in 1969 added to the rise in costs.

In virtually all of the industrial countries year-to-year price increases were larger in 1969 than in 1968. In the United States the GNP price deflator rose by 4¾ per cent in 1969, compared with 4 per cent in 1968, and at year-end the

GROSS NATIONAL PRODUCT PRICE DEFLATOR



Consumer Price Index was 6 per cent higher than a year earlier as against a rise of 4¾ per cent during 1968. For all the industrial countries combined, the OECD estimates that the increase in the GNP price deflator was 4¾ per cent compared with less than 4 per cent in 1968. This was a continuation of the deterioration in price performance of this group of countries from an average increase of 2½ per cent per year over the first half of the 1960's to an average increase of 3½ per cent per year over the past five years. The acceleration between these two periods has been most noticeable in Canada and the United States, the countries which enjoyed the best price performance in the first half of the decade.

Inflation has thus become more generalized and serious than at any time since the early 1950's, and in most of the industrial countries high priority is now being given to anti-inflationary policies. In the United States, fiscal and monetary policy has been used vigorously to restrain demand. As a result of the tax increase in mid-1968 and a limitation on both military and civil expenditures the federal budget swung from a deficit of $25 billion in the fiscal

year ending mid-1968 to a surplus of $3 billion in fiscal 1969. A smaller surplus is officially projected in the current fiscal year.* Monetary policy applied increasing constraint on the reserve position of the commercial banks during the first half of 1969 and this pressure was maintained throughout the second half; the growth in loans and investments of commercial banks was held to 2½ per cent during 1969, compared with 11 per cent during the previous year. Credit conditions tightened generally in the course of the year and interest rates rose. The yield on three-month Treasury bills exceeded 8 per cent at year-end, almost two full percentage points above a year earlier, while the yield on new issues of long-term high-grade corporate bonds exceeded 8½ per cent compared with 7 per cent at the beginning of the year. Interest rates moved down in the first months of 1970.

In Britain restrictive policies have been followed for several years to contain inflationary demands and to strengthen the balance of payments position. The deterioration in the French balance of payments and the severe inflationary pressure which followed the events of May and June 1968 led the authorities to take a number of measures, including the devaluation of the franc in August 1969, to restore both internal and external equilibrium. In Germany strong inflationary pressures emerged earlier in the year, and the authorities now look to the revaluation of the mark and measures of domestic financial restraint to restore internal balance in the economy. Concern about signs of an over-heating of the Japanese economy was expressed by the authorities last September when the Bank Rate was increased.

BALANCE OF PAYMENTS DEVELOPMENTS**

The widespread strength of demand was reflected in a growth in the volume of world trade close to the record 12 per cent increase achieved in 1968. In value terms the increase was higher in 1969 as export prices rose between 2 per cent and 3 per cent on average compared with a 1 per cent decline in the previous year. World prices of basic commodities in particular rose sharply. The increase was most pronounced in metals but prices of a wide range of industrial materials and many foodstuffs were higher, though wheat was a notable exception.

While current account imbalances remained large some progress towards achieving more viable positions was discernible by year-end. In the United States, the current account including unilateral transfers was in deficit during the first half of the year, but a recovery in the merchandise trade surplus during the second half of the year brought the current account back to about a balanced position. This improvement still leaves the United States balance well short of the current account surplus of over $3½ billion achieved, on average, in the

* The surtax on corporate and personal tax liabilities which was scheduled to expire at the end of 1969 was extended to the end of June 1970 at half the original 10 per cent rate.
** All values in this section are expressed in U.S. dollars.

years 1964-67. Britain has been in a position to take advantage of buoyant world demand and its current account surplus in the second half of 1969 appears to have been running at a rate consistent with the longer-term objective of $1.2 billion per year. Although the French deficit on current account in 1969, at more than $1 billion, was considerably larger than in 1968 there were signs at year-end that the trade deficit was contracting. In the second half of 1969 the German current account surplus ran at an annual rate of almost $2½ billion, nearly as large as in 1968, though it is expected to decline as the impact of revaluation is felt. The Italian surplus for the whole of 1969 does not appear to have fallen much from the level of more than $2½ billion in 1968, but the trend at year-end was obscured by widespread work stoppages. The Japanese surplus more than doubled to over $2 billion in 1969 as the exceptionally rapid growth in that country's exports continued.

During the course of 1969 there were extraordinarily large flows of short-term capital which at times placed severe pressure on the international payments system. The Euro-dollar market was the principal channel for these flows, and heavy demands for funds caused rates to rise dramatically in the first half of the year and to remain very high throughout the rest of the year. During the first half of the year, United States banks drew more than $6 billion from the Euro-dollar market through their foreign branches in order to offset the loss of term deposits associated with the Regulation Q ceiling on domestic deposit rates.* At the end of June the United States monetary authorities proposed that reserve requirements should be imposed on increases in United States banks' liabilities to foreign branches** and only limited net use was made of this market during the rest of the year. During the latter months of the year there was some recourse by United States banks to direct borrowing from official holders abroad rather than through the Euro-dollar market.

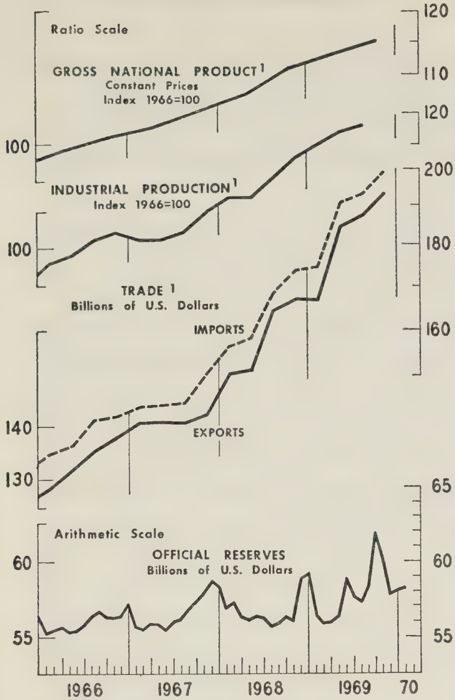
Sporadic demands for short-term funds were associated with speculation that Germany would revalue the mark. Expectations of an imminent change in the exchange rate of the mark led to a surge of about $4 billion into Germany in late April and early May, drawing funds from many countries including France, where there was speculation that the French franc would be devalued. The authorities succeeded in dispelling expectations of an immediate change in exchange rates and some reversal of the flow to Germany took place in late May and June. In the uneasy calm that prevailed during the summer months the French franc was devalued by 11.1 per cent in mid-August. The approach of the German election in late September brought on a renewed wave of speculation that the mark would be revalued causing a further flow of some $2 billion into

* Early in 1970 there was an upward adjustment of maximum interest rates under Regulation Q on time and savings deposits. The top rate for single maturity time deposits of $100,000 or more was raised to 7½ per cent for maturities of one year or more, from the previous maximum of 6¼ per cent.

** Under a regulation announced in August a 10 per cent reserve requirement was imposed, beginning October 16, on borrowings by member banks from their foreign branches in excess of the average amount outstanding during the four-week period ending May 28, 1969.

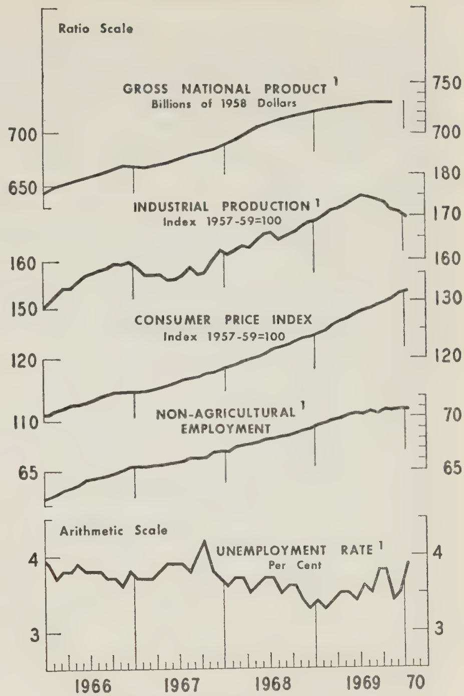
ECONOMIC INDICATORS

ALL O.E.C.D. COUNTRIES



1. Seasonally adjusted: Trade at annual rates.

UNITED STATES



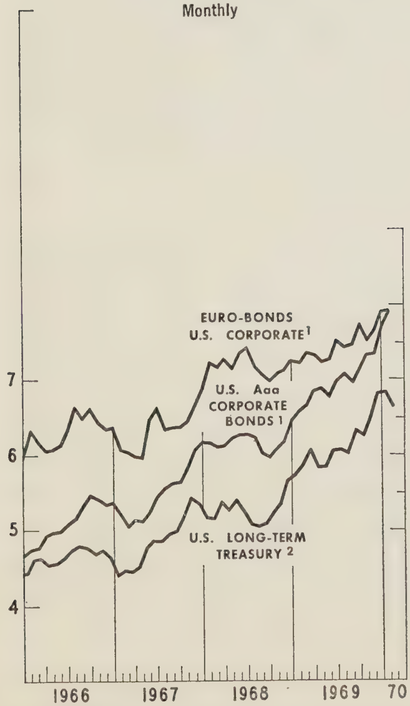
1. Seasonally adjusted: GNP at annual rates.

INTEREST RATES

Per Cent

LONG-TERM

Monthly



1. Month-end.
2. Average of daily figures.

SHORT-TERM

Weekly

1. Average of daily figures.
2. Ceiling rate on 90-179 days deposits under Regulation Q.

Germany. The German authorities closed the exchange market, allowed the mark to float upwards for four weeks, and at the end of October established a new official parity 9.3 per cent higher than the previous one. This was followed by a very large reflux of funds from Germany, much of it apparently going to the United States.

The strains on the payments positions of individual countries caused by the speculative flows of funds were eased to some extent by the use of both new and existing credit facilities between official institutions. Among the facilities already in position were four central bank networks in which Canada is a participant, namely, one in favour of the Bank of England set up at the time of the devaluation of sterling in November 1967, a second in favour of the Bank of England set up in September 1968 in connection with an arrangement to discourage the conversion into other currencies of sterling held by countries of the sterling area, one in favour of the Bank of France set up in November 1968, and the very large structure of reciprocal facilities between the Federal Reserve System and a number of other central banks. The network in favour of the Bank of France, in which Canada's share was $100 million, was terminated in the course of 1969. Canada's share in the other facilities remained unchanged during the year at $100 million in each of the networks in favour of the Bank of England and $1,000 million in the reciprocal network of the Federal Reserve System.

In 1969, as in 1968, there was again a substantial volume of foreign long-term borrowing in the main European markets, particularly in Germany. The total of new Euro-bond issues was above the $3 billion level or only a little below the 1968 total, despite a decline in issues by United States companies from $2 billion to $1 billion. There was also a large volume of foreign issues denominated in German marks placed directly in the German market, including new issues by Canadian borrowers equivalent to more than $400 million. In total, the German capital market provided about $5 billion of long-term capital to foreigners in 1969, about twice as much as in 1968.

There were major changes from 1968 to 1969 in the capital account of the United States balance of payments. The large inflow of funds associated with substantial non-resident purchases of American equities and other non-government securities fell off sharply after the first quarter of 1969, and the net inflow from foreign official purchases of special United States Treasury certificates, which had been large in 1968, did not continue in 1969. At the same time there appears to have been an increase in the outflow of private long-term capital, presumably reflecting in part the liberalization of balance of payments guidelines in 1969. There was also a large outflow under the "errors and omissions" item in the first three quarters, most of which probably reflected a flow of United States funds to the Euro-dollar market. These developments contributed to the swing in the liquidity balance from a position of approximate

balance in 1968 to a substantial deficit in 1969. The large inflow of funds through banking channels, noted earlier, did not reduce the liquidity deficit because the resulting indebtedness is recorded as a liquid liability to non-residents. On an official settlements basis, which indicates more accurately the position of the U.S. dollar in exchange markets, there was a surplus of about \$2¾ billion, composed of a decline in liabilities to foreign official institutions of about \$1.5 billion and an increase in official reserve assets of \$1.3 billion.

The strengthening of Britain's current account position in 1969 and an inflow of capital has permitted that country to commence repayment of drawings on international credit facilities and to add to its reserves. During the past year Japan has been shifting the financing of its trade from foreign to domestic sources and the resulting net outflow of capital has helped to offset a part of its large current account surplus, but there was also an increase of more than \$0.7 billion in its reserves. Italy's large current account surplus was exceeded by even larger net capital exports and its reserves show a decline of \$0.4 billion. In the first nine months of 1969 Germany's net export of long-term capital substantially exceeded its current account surplus but speculative inflows were sufficient to increase German official reserves by more than \$2 billion. In the last three months of the year the return flow of speculative funds contributed to a decline in German reserves of about \$5 billion.

Economic Developments in Canada

GENERAL REVIEW

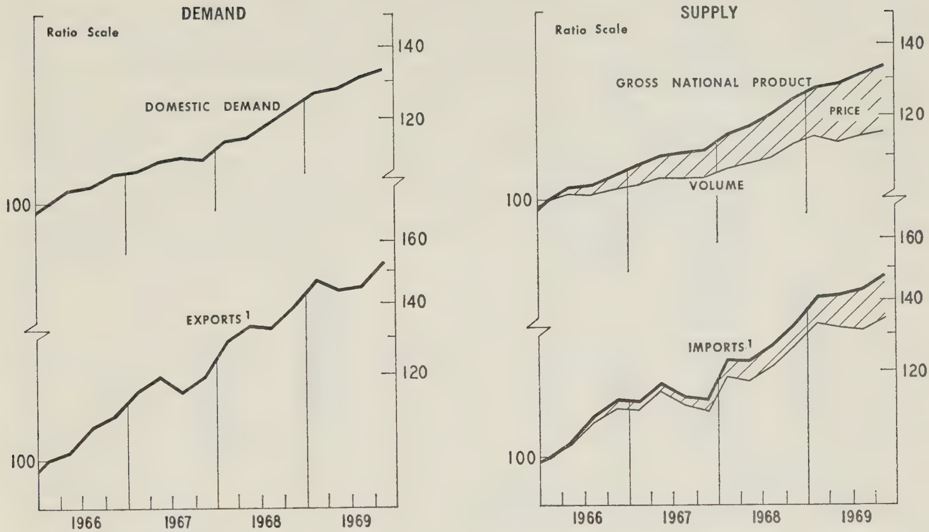
The course of economic activity in Canada in 1969 was badly distorted by strikes. However, it appears that following a vigorous expansion from late 1967 through the first quarter of 1969, the underlying trend of demand grew at an appreciably slower pace. Exports, which had been one of the most dynamic elements of total demand in the period of rapid growth, provided considerably less stimulus after the first quarter. This reflected some major strikes which disrupted trade from the second quarter until late in the year, the slowing of the expansion of the United States economy during 1969 and the weakness of the world wheat market.

The less rapid rise in exports was accompanied by a moderation in the growth of domestic demand in response to tightening fiscal and monetary restraints. Consumer spending on durable goods rose more slowly as the market for new cars weakened, initially in the spring but more markedly towards year-end. Outlays on residential construction, which had been rising very rapidly, levelled off about mid-year. Business investment in inventories was at a much lower rate after the first quarter. On the other hand, business investment in plant and equipment continued to rise moderately and a much larger increase would have occurred had it not been for major strikes in the construction industry. There was also an appreciable rise in government expenditure on goods and services in 1969 in response to rising costs, notably a substantial increase in the wage and salary bill of the public sector.

In the aggregate, and after allowance for strike distortions, the growth of demand in money terms since the first quarter of 1969 seems to have been at an annual rate of about 7½ per cent, compared with more than 10 per cent during the preceding six quarters. Since the prices of goods and services rose more rapidly in the recent period, the deceleration in terms of volume was even more pronounced. Imports also grew more slowly after the first quarter of 1969; indeed, over the balance of the year there was scarcely any increase in volume.

MAJOR ECONOMIC AGGREGATES

Quarterly — Index 1Q 1966=100



Seasonally adjusted.
1. Goods and services.

OUTPUT. The expansion in the volume of output decelerated somewhat later in Canada than in the United States and, while the slowing here was more abrupt, the economy was still registering more growth at year-end. Canadian output was severely affected by a series of major labour disputes beginning in the second quarter and continuing with varying impact until late in the year. These occurred first in the construction and iron ore industries, then in steel and nickel. For 1969 as a whole, 7¾ million man-days were lost as a result of strikes, 50 per cent more than in either 1968 or 1966, both of which were also affected by strikes to an exceptional degree. Though the level of activity was still influenced to some extent by strikes well into the fourth quarter, their impact had been considerably reduced, contributing to a strong rebound in output at year-end. In the United States, on the other hand, a major strike in the electrical industry had a weakening effect on total output in the fourth quarter.

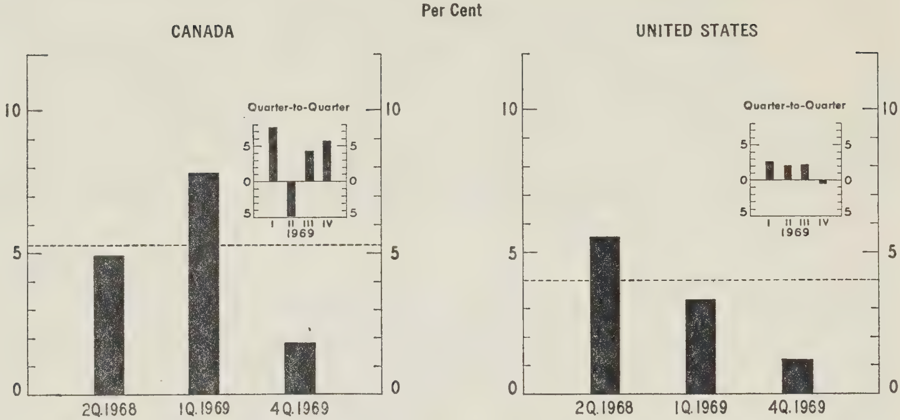
Perhaps the most meaningful way of assessing recent trends is to compare the growth between the first and fourth quarters of 1969 with the two earlier three-quarter periods. In Canada, real output grew during the recent period at an annual rate of less than 2 per cent compared with an average annual rate of 6½ per cent during the preceding year and a half. The comparable annual rates of growth in the United States were 1¼ per cent and 4½ per cent.

VOLUME OF OUTPUT[1]

Average Annual Rates of Growth in Constant Dollar G.N.P.

3 Quarters Ending

Per Cent



Seasonally adjusted.

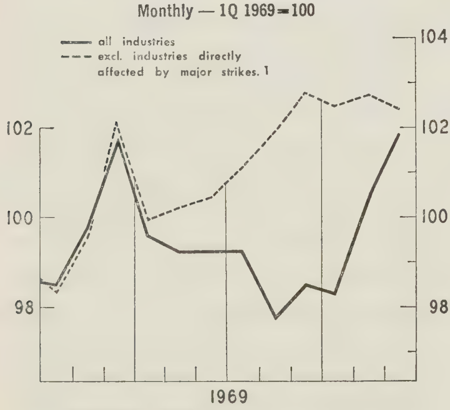
1. Broken horizontal lines represent potential rates of real growth : these are estimated for Canada by the Economic Council of Canada and for the United States by the Council of Economic Advisers.

Excluding industries affected by strikes, the rate of real growth in Canada in the last three quarters of 1969 seems to have been about 3 per cent per annum.

The impact of strikes in the industrial sector is illustrated in the accompanying chart. This suggests that the index of industrial production (which covers about one third of total output in the economy) would have followed a very different pattern if several industries had not been affected by prolonged work stoppages. Excluding strike-affected industries, industrial output rose moderately until the end of the third quarter, then levelled out. There was some decline in production of primary textiles and around the end of the year a marked reduction in automobile assemblies, reflecting weakening demand in North America. There was also a drop in lumber production from its high level in the early part of 1969, as house-building activity slowed in Canada and the United States.

INDEX OF INDUSTRIAL PRODUCTION

Monthly — 1Q 1969=100



Seasonally adjusted.

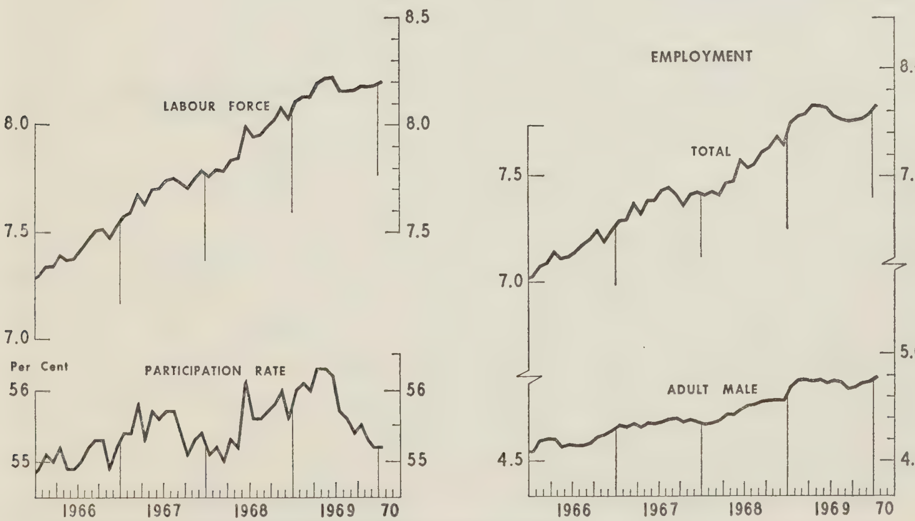
1. Industries excluded : iron mines, miscellaneous metal mines, iron and steel mills, and smelting and refining. These industries together account for about one-eighth of the total index.

Farm output appears to have increased at about the same rate as in the previous year. Although the adverse wheat marketing situation induced Prairie grain growers to cut back acreage sharply, unusually favourable growing conditions resulted in near-record yields and a large high-quality crop. This high production in the face of a major decline in exports of wheat and flour in 1969 led to the accumulation of very large stocks of grain both in commercial positions and on Prairie farms. Late in the year, the signing of new contracts with the Soviet Union and China helped to ease the marketing situation somewhat. The general weakness in the world wheat market was reflected in a sharp drop in prices in 1969, but in recent months they appear to have stabilized at a relatively low level.

EMPLOYMENT AND PRODUCTIVITY. According to labour force statistics, employment reacted very promptly to the trend of output. Indeed, total employment (seasonally adjusted) declined for several months after mid-year, though some pick up occurred again at year-end. There appears to have been an unusually large increase in students employed in the late spring followed by a reduction as the summer progressed. Another factor which probably influenced the trend of employment was the indirect effect of labour disputes even though striking workers themselves are counted as employed. Adult male employment

LABOUR FORCE AND EMPLOYMENT

Monthly — Millions



Seasonally adjusted: Adult male employment adjusted by Bank of Canada.

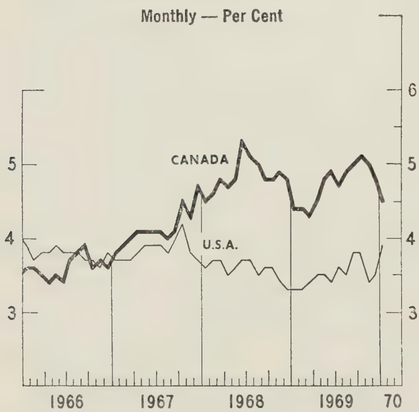
did not weaken as much as total employment last summer; indeed, it was virtually level after a sharp increase at the beginning of the year.

Labour force growth appears to have been responsive to changing employment opportunities to a remarkable degree during 1968 and 1969. The proportion of the population of working age participating in the labour force rose strongly through 1968 and early 1969 and declined sharply thereafter. As a result, the labour force increased by about 4¼ per cent between the first quarter of 1968 and the first quarter of 1969, but only at an annual rate of about one per cent between the first and fourth quarters of 1969. These rates compare with an underlying growth trend in the labour force of about 3 per cent per annum. While the main explanation for these variations over the past two years can be found in the labour force participation rates of married women, students and older workers, there was an unusual drop in 1969 in the participation rates of adult male workers, which can be explained only in part by increased enrolment in retraining programmes.

Owing to the sensitivity of labour force participation to changes in labour demand, the number of unemployed has fluctuated within a fairly narrow range during the past two years. On a seasonally adjusted basis, the unemployment rate exceeded 5 per cent of the labour force in the summer of 1968, fell below 4½ per cent in the first quarter of 1969, rose to about 5 per cent in the autumn, then declined again to 4½ per cent in January. Throughout this period, unemployment remained above the low point reached in 1966 when the average for the whole year was about 3½ per cent. This was in marked contrast to the situation in the United States where the unemployment rate over the past two years has generally remained exceptionally low.

UNEMPLOYMENT RATES

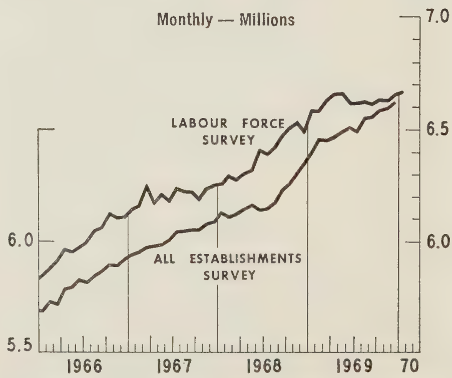
Monthly — Per Cent



Seasonally adjusted.

NON-FARM EMPLOYMENT
Paid Workers

Monthly — Millions



Seasonally adjusted : All Establishments Survey adjusted by Bank of Canada.

The above analysis of labour market developments has focussed exclusively on data provided by the labour force survey. It should be noted that alternative official measures of employment convey a somewhat different impression. Direct estimates, based on payroll information rather than the household sample survey, suggest that the growth of employment was better sustained throughout 1969. For this reason, and because of the disruptions caused by labour disputes, it is difficult to draw precise conclusions about the short-term trend of productivity. However, it does seem clear that, following exceptionally large productivity gains during the period of rapid growth, there has more recently been a marked deterioration in performance such as usually occurs when the pace of expansion slows down.

PRICES AND INCOMES. The gradual accumulation of some slack in the economy has so far led to few definite signs of easing in prices and money incomes though some lag was, of course, to be expected. While some tentative signs of moderation did appear during the summer, price increases were slightly larger over 1969 as a whole than during the previous year. This marked the fourth consecutive year of clearly excessive rates of price increase. As noted in the preceding part of this Report, there were greater inflationary pressures in the United States and other industrial countries in 1969 than there had been for many years. These external developments not only had important effects through such direct channels as export and import prices but also tended to reinforce and prolong inflationary expectations and behaviour in Canada.

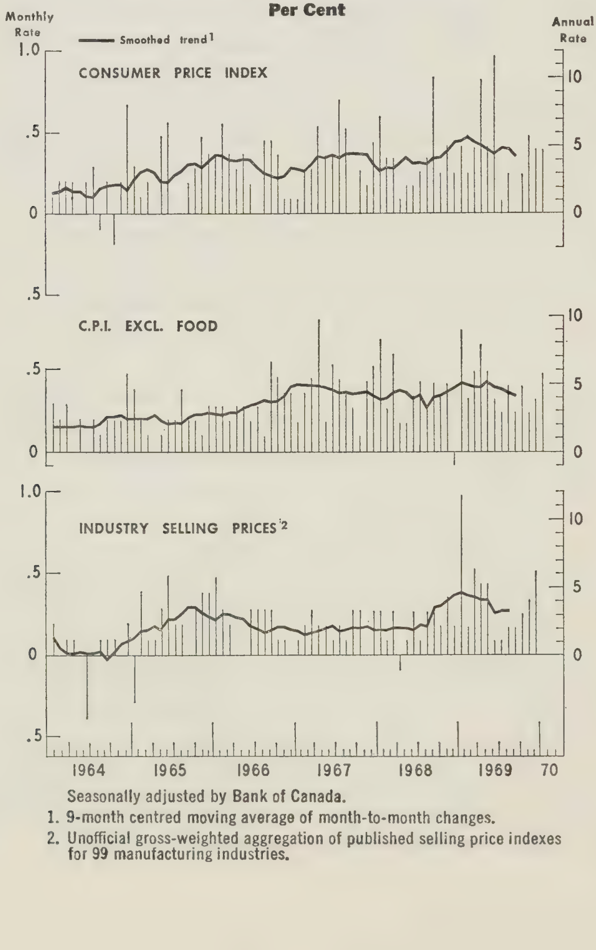
The Consumer Price Index in January 1970 was 4.6 per cent higher than a year earlier, compared with a 3.8 per cent increase during the preceding twelve-month period. Food prices rose by 4 per cent following an increase of 3 per cent the previous year. Excluding food, the index rose by 4.7 per cent, as against an increase of 4 per cent during the previous year. Prices of goods other than food increased at about the same rate in both years but shelter and service prices accelerated. Prices of durable goods increased somewhat faster than they did during 1968 but there was a slight moderation in the rise in prices of non-durable goods. Shelter costs advanced by about 7 per cent, somewhat more than in 1968: costs of home-ownership, including such items as mortgage interest rates, property taxes and insurance, again rose substantially, though there was a slightly smaller increase in rents. Prices of other consumer services also rose more than 7 per cent, representing a major acceleration from the previous year. Unusually large increases occurred in charges for local transportation and prepaid medical care. Given their labour-intensive character and the small scope for productivity improvement, the prices of services tend inevitably to reflect more directly than those of goods the continued rapid rise in wages and salaries. In addition, prices of many services are subject to regulation and are often adjusted to past cost increases only after appreciable time lags.

Many major components of the CPI moved up very sharply in the spring of 1969 when a rise in food prices, especially for beef, coincided with large increases in some service prices and higher sales or excise taxes on a number of other items in the index. After mid-year, food prices eased for several months and prices of other items appeared to be rising more moderately, but towards year-end the pace quickened again, notably in food and new car prices.

Because of so many irregularities, including the infrequency with which certain major service items are priced, it is difficult to identify changes in the underlying trend of prices. The accompanying chart attempts to do this by smoothing out the monthly changes in the CPI and in an aggregate index of industry selling prices, after adjusting for seasonal variation. All three measures show that price increases over the second half of 1969 were less than over the first half, though in the last two or three months there have been perceptibly

MONTHLY PRICE CHANGES

Per Cent



Seasonally adjusted by Bank of Canada.

1. 9-month centred moving average of month-to-month changes.
2. Unofficial gross-weighted aggregation of published selling price indexes for 99 manufacturing industries.

larger increases again, particularly at the earlier stages of the production process, as may be seen in the index of industry selling prices. Much of the easing in this measure during the summer was attributable to lumber prices, which fell back sharply from their exceptionally high level early in 1969. On the other hand, since the autumn there have been increases in prices of several important basic commodities, such as steel, nickel and newsprint, which are still working their way through to final product prices.

The most comprehensive measure of prices of domestically produced goods and services, the GNP deflator, showed a pronounced deceleration in the latter part of the year from its very high rate of increase in the second quarter. However, this measure is also extremely difficult to interpret on a short-run basis because of irregular influences and changes in weighting as expenditure patterns vary from quarter to quarter. From the fourth quarter of 1968 to the fourth quarter of 1969 the increase in the GNP index was 4½ per cent compared with a rise of less than 4 per cent the year before. The deflator for final domestic demand, which includes the cost of imported goods and excludes exports and inventories, increased slightly faster, by 4¾ per cent compared with about 4½ per cent during 1968. In addition to consumer purchases, such measures reflect prices of goods and services purchased by other sectors of the economy, some of which are very directly affected by wage costs and prices of imported goods. During 1969 there was a noticeable acceleration in the price components of business capital investment and government spending. The price of machinery and equipment, about half of which is imported, rose appreciably faster than in 1968. The more rapid increase in construction wages in 1969 contributed to an acceleration in the cost of both residential and non-residential construction, especially the latter. The cost of public works was similarly affected, but the major element in the 8½ per cent rise in the price of goods and services purchased by governments during 1969 was the large increase in rates of pay of employees in the public sector, which included at the federal level substantial retroactive salary payments.

In addition to being the broadest indicator of price movements in the economy, the GNP price index is equally a measure of the extent to which the increase in the total of money incomes and other costs accruing to factors of production exceeds the increase in total real output. The following table shows that, compared with the earlier period of relative price stability, the past several years have been marked by more rapid growth in labour costs per unit of output, accompanied by efforts on the part of business to restore profit margins when market conditions permitted, as in 1968.

The net contribution of the miscellaneous ("all other") income and cost components to the total price change has been relatively small except in 1966 when farm income increased quite sharply, primarily as a result of the record

AMOUNT CONTRIBUTED* TO PERCENTAGE INCREASE IN GNP PRICE INDEX BY DIFFERENT TYPES OF INCOME

Type of income	Annual average 1961-65	Annual average 1965-69	Second half to second half 1965-66	Second half to second half 1966-67	Second half to second half 1967-68	Second half to second half 1968-69
Corporate business(1)	0.6	–	−0.8	–	1.0	−0.6
Uninc. business (non-farm)	–	–	−0.2	0.4	–	−0.2
Total business	0.6	–	−1.0	0.4	1.0	−0.8
Wages and salaries(2)	0.9	3.1	3.8	2.9	1.6	4.0
Indirect taxes(3)	0.6	0.6	0.3	0.7	0.7	0.8
All other GNP components	0.1	0.3	1.9	−0.7	0.3	0.5
GNP price index(4)	2.2	4.0	5.0	3.3	3.6	4.5

* The contributions are calculated by weighting changes in each category of income per unit of total output by its share of GNP in 1961. The weights used are: total business 21.1; wages and salaries 52.2; indirect taxes 12.5; and all other GNP components 14.2.

(1) Corporation profits before taxes and corporation capital cost allowances.

(2) Includes supplementary benefits and military pay.

(3) Less subsidies.

(4) The GNP "deflator" which measures prices of all goods and services produced.

wheat crop that year. The increases in indirect taxation which have accompanied the growth in the relative size of the government sector have made a significant contribution to the rise in prices, but this has been no greater in recent years than in the early 1960's. Business income per unit of output, particularly in the corporate sector, has been more volatile, and from time to time has contributed significantly to the over-all rise in income per unit of output, most recently in the period of economic expansion during 1968 and early 1969. In the course of 1969, however, a renewed squeeze on profit margins developed, as is also shown in the chart on page 34.

As business income accounts for only a fifth of GNP and as some of its components are relatively stable, the changes in the contributions of this factor in the foregoing table are mainly the result of quite large swings in corporate profits. Corporation profits before taxes (though after depreciation) rose by 21 per cent between the second halves of 1967 and 1968; they remained at a high level until the second half of 1969 when they fell sharply, in part as a result of the major strikes mentioned previously. In this period, profits averaged about 3 per cent lower than in the second half of 1968.

While there was some deceleration in the rise in total wages and salaries in the course of 1969 as employment grew more slowly, labour income in the second half of the year was still 12 per cent higher than in the corresponding period of 1968. Between the second halves of 1967 and 1968 when there was an unusually strong gain in productivity, labour income per unit of output had risen by 3 per cent, compared with an average annual increase of under 2 per

cent in the 1961-65 period of relative price stability. Over the most recent year, with average pay increases remaining at least as large and with productivity deteriorating as the economic expansion slowed, there was a sharp acceleration in unit labour costs; they were 7½ per cent higher in the second half of 1969 than in the same period of 1968. Given the important share of GNP represented by wages and salaries—more than half—this sharp rise in unit labour costs meant that they accounted for more than four fifths of the increase in the total of all incomes per unit of output between the second half of 1968 and the second half of 1969, as may be seen in the table on page 32.

In the economy as a whole there appears to have been a slightly larger increase in average income per employee in 1969 than in 1968. Explicit information about average wages and salaries is only available for larger establishments. This covers some 50 per cent of the work force but excludes all public employees. For this important group, average pay increases during 1969 were no larger than in the two preceding years, but they remained very much greater than average increases during the early 1960's. The table below also shows that in contrast to this over-all pattern, there was a substantially larger increase in the average pay of construction employees last year.

AVERAGE WEEKLY WAGES AND SALARIES[1]

(percentage increases)

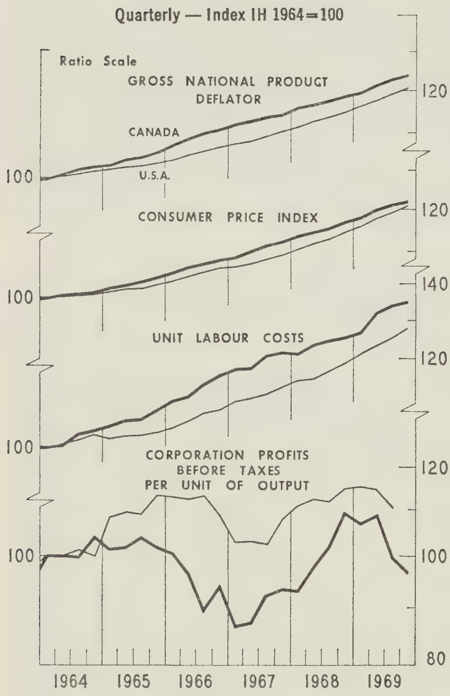
	Annual average		Second half to second half			
	1961-65	1965-69	1965-66	1966-67	1967-68	1968-69
Manufacturing	3.8	6.7	5.9	6.8	7.5	7.2
Mining	3.9	7.5	7.3	8.1	7.8	6.8
Forestry	5.2	8.4	9.0	8.3	7.3	9.6e
Construction	4.7	8.9	11.6	6.4	5.6	10.4
Transportation and utilities	4.4	7.6	3.6	10.9	8.5	8.9e
Trade	3.3	6.3	4.7	5.8	7.8	7.6
Finance insurance and real estate	4.9	6.5	4.8	6.4	8.5	5.7
Other commercial services	3.2	6.4	6.5	7.5	5.0	6.3
Total of above	3.8	6.7	5.7	7.0	7.2	7.1

e: Estimate.
(1) Based on payrolls of firms having 20 or more employees.

A more forward-looking, though less comprehensive, measure of the trend of wages and salaries is provided by the average increase in base rates under new collective bargaining agreements. While the weighted average of these annual increases (excluding construction) was 7.9 per cent in 1969, or about the same as in 1968, there was an accelerating trend after the first quarter. In the fourth

quarter such settlements provided for increases averaging almost 9 per cent and included some major industrial settlements providing for average base-rate increases over the life of the agreements of 10 per cent to 11 per cent per year. There were also very large settlements involving construction workers in most sections of the country last year. As usual, many contracts signed in 1969 called for immediate increases which were somewhat greater than the average over the life of the contract.

PRICES AND COSTS
CANADA - U.S.A.



Seasonally adjusted : C.P.I. adjusted by Bank of Canada.

Canada's price performance over the past year has compared more favourably with the United States than in other recent years. The 4½ per cent increase in the GNP deflator in Canada over the year ending in the fourth quarter of 1969 compared with a rise of about 5 per cent in the comparable United States measure. Consumer prices also rose appreciably less during the year than they did in the United States. This resulted in part from a more rapid increase of food prices in the United States last year. Indeed, somewhat weaker prices in the farm sector in Canada are one of the more significant differences which emerge in a comparison of the prices and cost situation in the two countries. On the other hand, unit labour costs in both countries climbed faster during 1969 with the increase in Canada being at least as sharp as in the United States. The squeeze on profit margins in Canada appears to have been somewhat more severe, though again strike effects complicate the comparison.

REGIONAL DEVELOPMENTS

The easing of activity in the economy as a whole is reflected to some degree in all regions, though here too there are difficulties in allowing for the impact of strikes. Labour income increased at a somewhat slower pace during the latter part of the year everywhere except in British Columbia. Retail sales also rose at an above-average rate in British Columbia but their growth slowed from the high

rate of 1968 in the Atlantic Provinces and Ontario, particularly in the former where a sharp decline occurred in the second quarter. In Quebec, retail trade continued to rise at much the same moderate pace as was experienced through most of 1968 following the immediate post-Expo set-back. It also continued to rise moderately in the Prairie Provinces despite a decline in Saskatchewan. The latter province felt the brunt of the continuing weakness in world wheat markets and the resulting sharp drop in farm income had a particularly depressing effect on sales of farm machinery. In addition, Saskatchewan has experienced difficulty in marketing its increased production of potash, even at much reduced prices. Manufacturers' shipments were off markedly in Ontario and British Columbia in the latter part of the year. Strikes were an important factor in Ontario but towards year-end, as output was recovering in the strike-affected industries, manufacturers' shipments were affected by production cut-backs in the automobile industry. In British Columbia, manufacturing was affected by declining lumber sales.

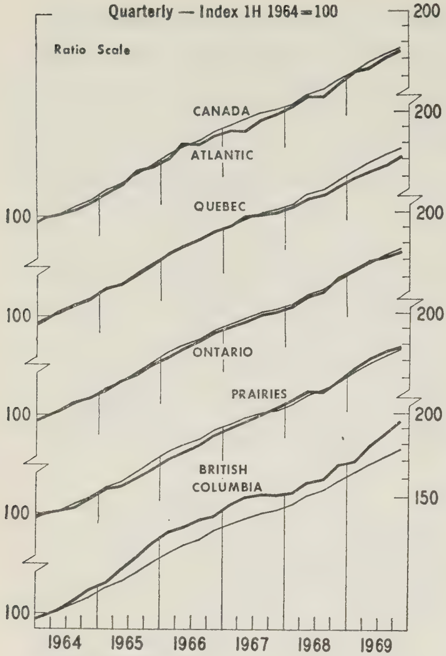
On a regional basis business investment apparently increased most in Ontario, the Atlantic region and British Columbia; in the Prairie region as a whole it remained at a high level, largely reflecting a strong gain in Alberta. In Ontario, business investment intentions for 1969 were up more than 20 per cent from actual 1968 outlays, but these plans were not fully realized. The main reason for the shortfall was a series of work stoppages in the construction industry during the summer; consequently it is likely that there has been an unexpectedly large carry over of uncompleted projects into the current year. Although investment intentions were up slightly in Quebec in 1969 it is not certain that the increase was achieved and investment per employee in that province remained relatively depressed. The achievement of a record level of housing starts nationally in 1969 was reflected in a high level of activity in all regions, though in Quebec and Ontario total starts per capita were lower than in 1968. The decline in starts which occurred in the latter part of the year was evident across the country.

The only region to experience a strong growth in employment in 1969 was British Columbia. In the Atlantic Provinces and Quebec the moderate growth in employment in 1969 represented a second year of relatively weak labour demand. In Ontario, and even more in the Prairie Provinces, the flat or downward trend of employment in 1969 was in sharp contrast to its rapid increase during 1968. The sensitivity of the growth of the labour force to the relative strength of labour demands was a feature common to all regions.

While the annual average rate of unemployment nationally was little changed between 1968 and 1969, there were significant differences in the pattern among the individual provinces. As may be seen in the table on page 38, unemployment in the Atlantic Provinces was generally higher in 1969, except in Nova Scotia, while it was lower in Ontario and all Western Provinces except

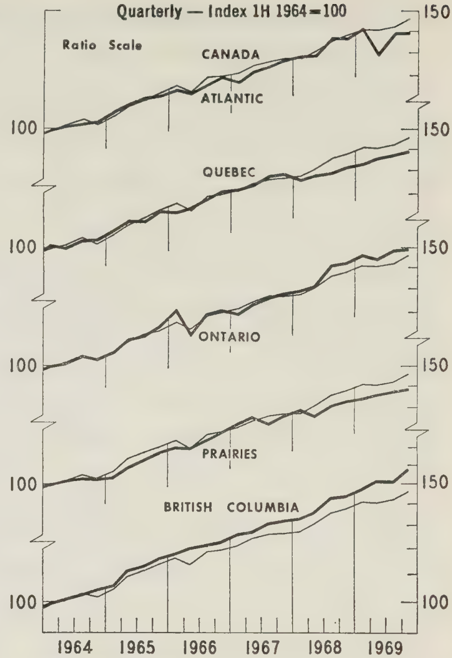
REGIONAL ECONOMIC INDICATORS

TOTAL WAGES AND SALARIES



Seasonally adjusted.

RETAIL SALES

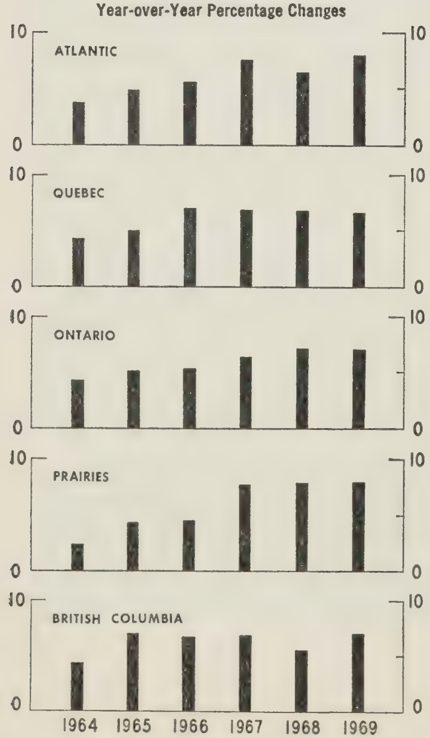


Seasonally adjusted.

AVERAGE WEEKLY WAGES AND SALARIES

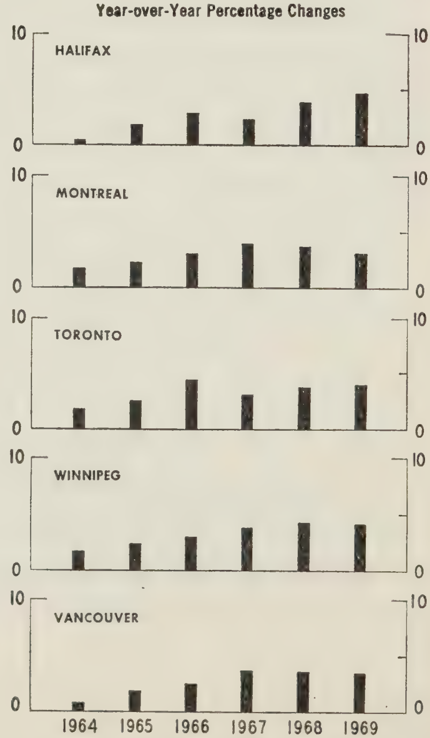
Industrial Composite

Year-over-Year Percentage Changes



CONSUMER PRICES

Year-over-Year Percentage Changes

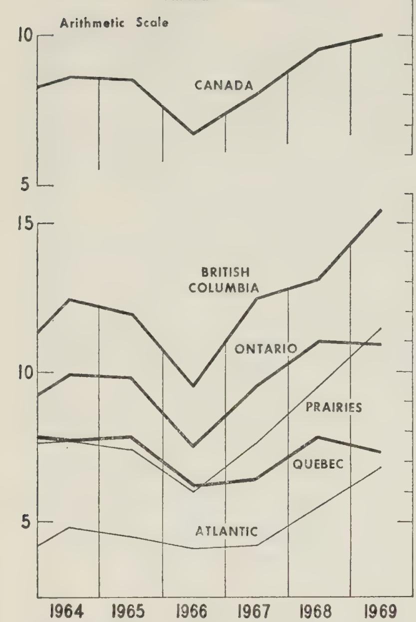


REGIONAL ECONOMIC INDICATORS

HOUSING STARTS

Per Thousand Persons

Annual — Units

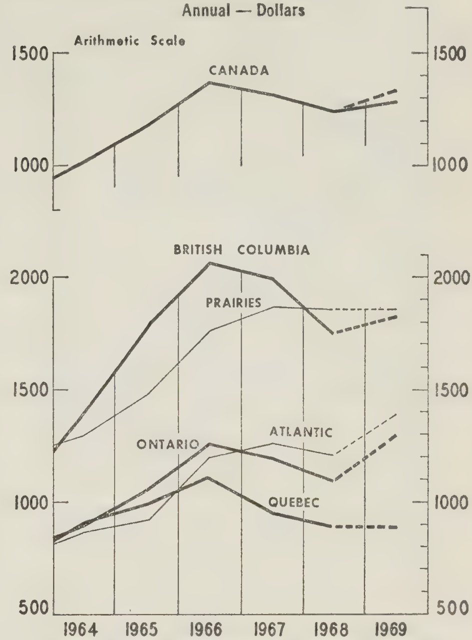


BUSINESS FIXED INVESTMENT[1]

EXCL. HOUSING

Per Employee

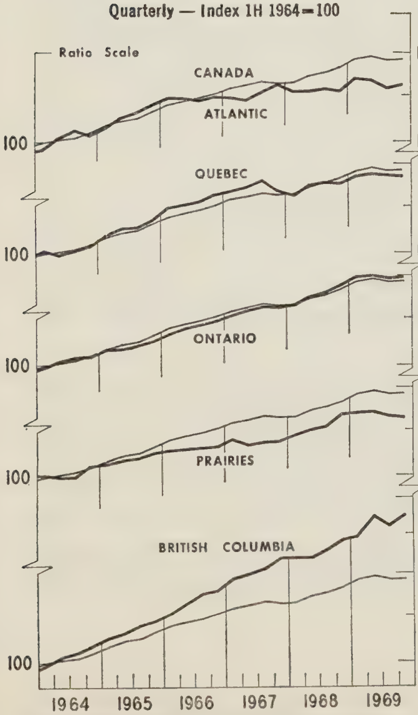
Annual — Dollars



1. Broken lines indicate mid-year intentions for 1969. Actual outlays are not yet available by regions.

EMPLOYMENT

Quarterly — Index 1H 1964=100



Seasonally adjusted : Based on Labour Force Survey.

UNEMPLOYMENT RATES

Quarterly — Per Cent

Seasonally adjusted.

PROVINCIAL UNEMPLOYMENT RATES

(per cent)

	Annual				Fourth quarter(1)	
	1966	1967	1968	1969	1968	1969
Newfoundland	7.9	8.4	9.7	10.3	8.4	8.9
Prince Edward Island	5.6	5.6	5.6	5.3	2.8	5.3
Nova Scotia	5.2	5.6	5.9	5.4	4.7	4.7
New Brunswick	6.9	6.9	7.2	8.5	6.8	6.3
Quebec	4.7	5.3	6.5	6.9	6.0	6.3
Ontario	2.5	3.1	3.5	3.1	2.7	2.8
Manitoba	2.5	2.5	3.5	2.7	3.2	2.2
Saskatchewan	1.5	1.8	2.3	3.1	2.3	3.8
Alberta	2.1	2.4	3.0	2.7	2.3	2.8
British Columbia	4.5	5.1	5.9	5.0	5.5	5.3
Canada	3.6	4.1	4.8	4.7	4.2	4.3

(1) Not seasonally adjusted.

Saskatchewan; in Quebec the rate increased for the fourth successive year, though more slowly than in 1968.

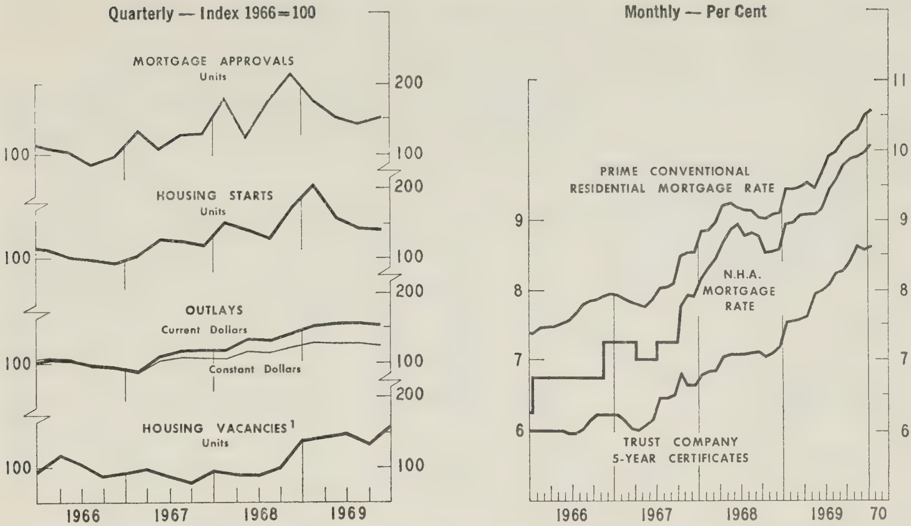
The foregoing developments are summarized in the charts on the two preceding pages. These charts also show that the inflation of recent years, as reflected in rising consumer prices and average weekly wages and salaries, has been shared by all regions to a strikingly similar degree.

SPENDING AND FINANCING BY MAJOR SECTORS

HOUSING SECTOR. The strongly rising trend of residential construction activity which began in 1967 continued until the early part of 1969 and the volume of outlays remained at a record level until late in the year, when there was some easing in activity.

Housing starts reached a very high seasonally adjusted rate in the early months of 1969. Subsequently, the number of starts dropped back but, for the year as a whole, they totalled 210 thousand units compared with the previous year's record of 197 thousand; most of the increase was in apartments and row housing. There were 196 thousand completions in 1969, 25 thousand more than in the previous year. The number of newly completed but unoccupied dwellings, which had been at a very low level until the latter part of 1968, was

HOUSING AND MORTGAGE MARKET



Seasonally adjusted at annual rates.
1. Newly completed only, unadjusted.

appreciably higher throughout 1969, suggesting a slight easing in the backlog of unsatisfied demand. Despite the slowing in starts, there were more units under construction at the end of 1969 than a year earlier.

While the slowing in housing activity in recent months reflects some reduction in the availability of mortgage financing, the rising costs associated with housing have also probably acted to limit effective demand. Construction costs continued to increase rapidly, though less sharply after mid-year as lumber prices eased. Financing costs also rose substantially in 1969. Typical interest rates on prime conventional mortgages increased from about 9 per cent at the end of 1968 to 10½ per cent at the end of 1969.

For the year as a whole, the total value of new residential mortgage approvals by financial institutions and CMHC was almost as high as in 1968, although there was a declining trend through most of 1969 from the extremely high level reached in the latter part of 1968. CMHC's direct lending rose from $456 million to $549 million in 1969, and there was a major change in the orientation of its activity; loans for low income housing almost doubled, from $228 million to $423 million. Loans approved by private institutions declined by $107 million in 1969 following a substantial rise of $694 million in the previous year. The value of mortgage loans approved by the chartered banks (including their mortgage lending subsidiaries), which had increased markedly

GROSS RESIDENTIAL MORTGAGE LOAN APPROVALS

(millions of dollars)

	Semi-annual				Annual		
	1968		1969				
	1st half	2nd half	1st half	2nd half	1967	1968	1969e
New housing							
Private financial institutions(1)							
Conventional loans	478	485	628	359	745	963	987
NHA insured loans	393	439	383	318	356	832	701
Sub-total	871	924	1,011	677	1,101	1,795	1,688
CMHC	154	302	183	366	685	456	549
Total new housing	1,025	1,226	1,194	1,043	1,786	2,251	2,237
Existing housing	295	324	399	333	697	619	732
Total	1,320	1,550	1,593	1,376	2,483	2,870	2,969

e: Estimate.

(1) Includes: life insurance companies, chartered banks, trust and mortgage loan companies, Quebec savings banks, fraternal and mutual benefit societies.

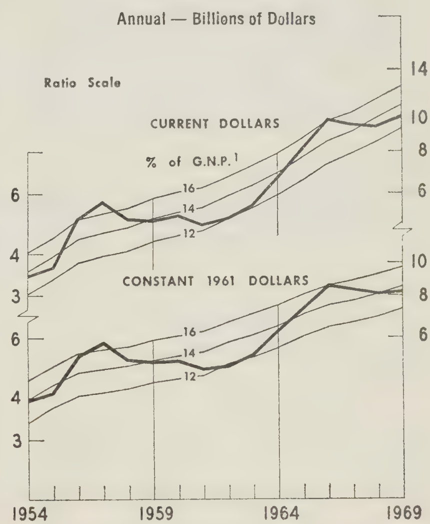
in 1968, decreased somewhat in 1969 and approvals by life insurance companies declined substantially. Indeed, the trust and mortgage loan companies were the only group of private lenders to increase significantly their approvals on new construction in 1969 and there was also an appreciable increase in their loans on existing houses.

Tight credit conditions have not had as great an impact on the supply of mortgage money as might have been expected on the basis of past experience. The trust and mortgage loan companies were able to attract a substantial volume of term deposits in 1969 (see page 58). Other factors helping to sustain the flow of funds into housing in 1969 were the greater flexibility of mortgage interest rates and the willingness of borrowers to pay very high rates, no doubt in part because of continued inflationary expectations.

In the course of the year further changes were made in the conditions of lending under the National Housing Act. In April the regulations were amended to permit the reduction of the original term of NHA insured mortgages to five years and to increase the amount of the maximum mortgage for new houses. At mid-year the Act was amended to eliminate the ceiling on the maximum interest rate on loans insured under the Act and to increase the maximum mortgage obtainable under the NHA on existing houses.

BUSINESS SECTOR. Business investment in new plant and equipment, which declined slightly in 1967 and 1968 after several years of very rapid increase, rose moderately again in 1969 to just above the 1966 peak. Such investment in 1969 was almost 7 per cent higher in value terms than in 1968. Non-residential construction outlays, which earlier had been expected to rise by as much as 15 per cent, were considerably affected by work stoppages during the summer and are now estimated to have risen by about 5 per cent. The sharp increase in construction costs more than accounted for this rise. Investment in machinery and equipment appears to have largely fulfilled earlier expectations, rising by about 8½ per cent. Prices of equipment rose only moderately and there was an appreciable rise in the physical volume of equipment put in place. On balance, the physical volume of total business investment increased only slightly and in relation to GNP continued to run at a level that was mid-way between the highs and lows of the 1960's. (See chart)

BUSINESS FIXED INVESTMENT
Excluding Housing



1. The contour lines enable one to see the ratio of investment to GNP in each year.

Business investment in inventories did not increase substantially after the first quarter of the year. Labour disputes, especially in heavy industry, interrupted supplies of many important materials and there was pressure to economize on inventory as credit conditions tightened. The stocks-to-shipments ratio in manufacturing was quite moderate at year-end.

The increase in dollar outlays on capital investment by the private sector occurred at a time when internally generated cash flow was slowing as a result of the squeeze on profits. While total funds from current operations were higher for the year as a whole than in 1968, available cash was reduced by the acceleration of corporation income tax collections announced in the October 1968 budget of the Government of Canada and in Ontario by a similar provincial measure in March 1969. In the event, funds raised externally by business during 1969 were considerably higher than in 1968—increasing by almost one third from identifiable sources.

While about the same amount of funds was obtained from non-resident direct investment in Canada as in 1968, investment by Canadian companies abroad was appreciably higher than in the previous year. Canadian direct invest-

MAJOR SOURCES OF EXTERNAL FUNDS OBTAINED BY NON-FINANCIAL BUSINESS

(millions of dollars)

	Semi-annual				Annual		
	1968		1969				
	1st half	2nd half	1st half	2nd half	1967	1968	1969
Net new issues of:							
Stocks	200	370	473	270	374	570	743
Convertible bonds	49	10	116	25	7	59	141
Other bonds	374	260	234	272	802	634	506
Commercial paper and bankers' acceptances	53	47	138	164	85	100	302
Sub-total	676	687	961	731	1,268	1,363	1,692
Increases in loans:							
Chartered banks(1)	366	269	1,111	194	602	635	1,305
Sales finance companies	127	119	79	107e	144	246	186e
Industrial Development Bank	21	21	23	31	34	42	54
Sub-total	514	409	1,213	332e	780	923	1,545e
Net direct investment from abroad	200	275	205	165	566	475	370
Total	1,390	1,371	2,379	1,228e	2,614	2,761	3,607e

e: Estimate.

(1) Total business loans excluding provincially-guaranteed loans to utilities, plus foreign currency loans to residents.

ment in the United States was substantially higher and accounted for about two thirds of the outflow in 1969; there was also some increase in investment in developing countries largely offset by a decline in investment in developed overseas countries. Borrowing by business was particularly high in the first half of the year. In this period business loans from chartered banks rose very strongly and accounted for about one half of total business borrowing. In the second half of the year there was a substantial reduction in the amount of new external funds obtained by business, particularly from the chartered banks.

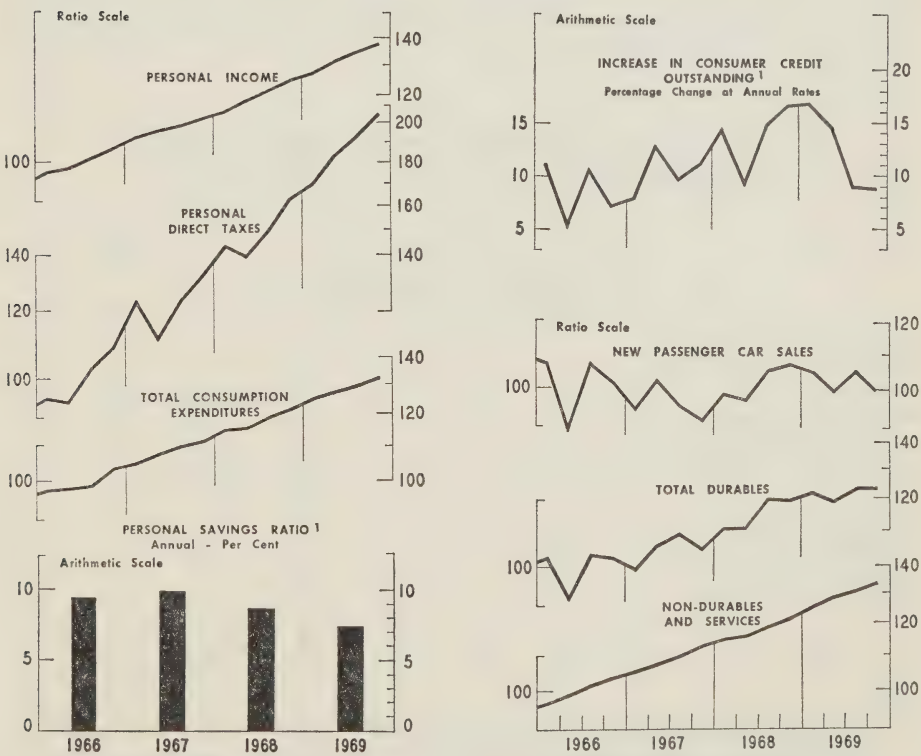
The form in which funds were raised in financial markets reflected a growing preference by Canadian investors for equities and short-term instruments, as distinct from long-term bonds. To the extent that business continued to borrow in the latter form, there was increased reliance on convertible bonds, on providing investors with early redemption options and on foreign markets. Sales of equities to non-residents also increased significantly. The geographic distribution of all corporate placements is shown in the table on page 61.

A comparison of the borrowing requirements of non-financial businesses to meet capital outlays with the external borrowing undertaken in 1969 suggests that there was again a substantial addition to their holdings of financial assets, though probably not as large as in 1968. It seems likely that part of the addition to liquidity last year was unintended and resulted from unforeseen delays in investment programmes.

PERSONAL SECTOR. Total consumer expenditure in 1969 increased by 9½ per cent, slightly more than in the previous year. The rise occurred despite a levelling off in total expenditure on durable goods, and the transfer of some medical expenses to the public sector. Car sales, which had been very strong, showed clear signs of an easing as early as the second quarter of 1969, and

PERSONAL INCOME AND CONSUMPTION EXPENDITURES

Quarterly — Index 1966=100



Seasonally adjusted.
1. Excluding farm inventories.

1. Fourth quarter 1969 is estimated.

exhibited more pronounced weakness around the end of the year. Outlays on household and other durables rose at about the same rate as in the previous year.

Incomes before taxes rose by over 10 per cent in 1969, slightly faster than in the previous year. A more rapid increase in labour income in 1969 was partly offset by a slowing in incomes from other sources, in particular by an actual decline in net income received by farmers. However, a sharp increase in personal income tax payments held the rise in personal disposable income to 8 per cent, about the same as in 1968. There was a further decline in the proportion of personal disposable income saved.

As shown in the chart on page 43, the growth of consumer credit slowed markedly in the second half of 1969. This was attributable to the restriction of lending by the chartered banks. After rising by $417 million, seasonally adjusted, in the first half of 1969, outstanding chartered bank unsecured personal loans increased by only $67 million in the second half of the year. For the year as a whole, such loans increased by about $200 million less than in 1968, but this was offset by credit extended by other lenders. Thus, as the table below shows, the increase in the total amount of consumer credit outstanding was slightly larger in 1969 than in 1968.

MAJOR SOURCES OF INCREASE IN CONSUMER CREDIT OUTSTANDING[1]

(millions of dollars)

	Semi-annual				Annual		
	1968		1969				
	1st half	2nd half	1st half	2nd half	1967	1968	1969
Increase in amount outstanding:							
Chartered banks (unsecured personal loans)[1]	264	424	505	– 23[2]	519	688	482[2]
Consumer loan companies	141	68	97	164	140	209	261
Sales finance companies	12	8	85	69	– 79	20	154
Credit unions and caisses populaires	84	69	45	76[e]	157	153	121[e]
Life insurance companies (policy loans)	40	27	33	59	36	67	92
Quebec savings banks	2	2	5	– 2[2]	1	4	3[2]
Retail dealers[3]	–124	194	– 97	217[e]	42	70	120[e]
Total	419	792	673	560[e]	816	1,211	1,233[e]

e: Estimate.

(1) Not seasonally adjusted. In the case of chartered bank unsecured personal loans the seasonally adjusted half year figures, in millions of dollars, were 194 and 495 in 1968 and 417 and 67 in 1969.

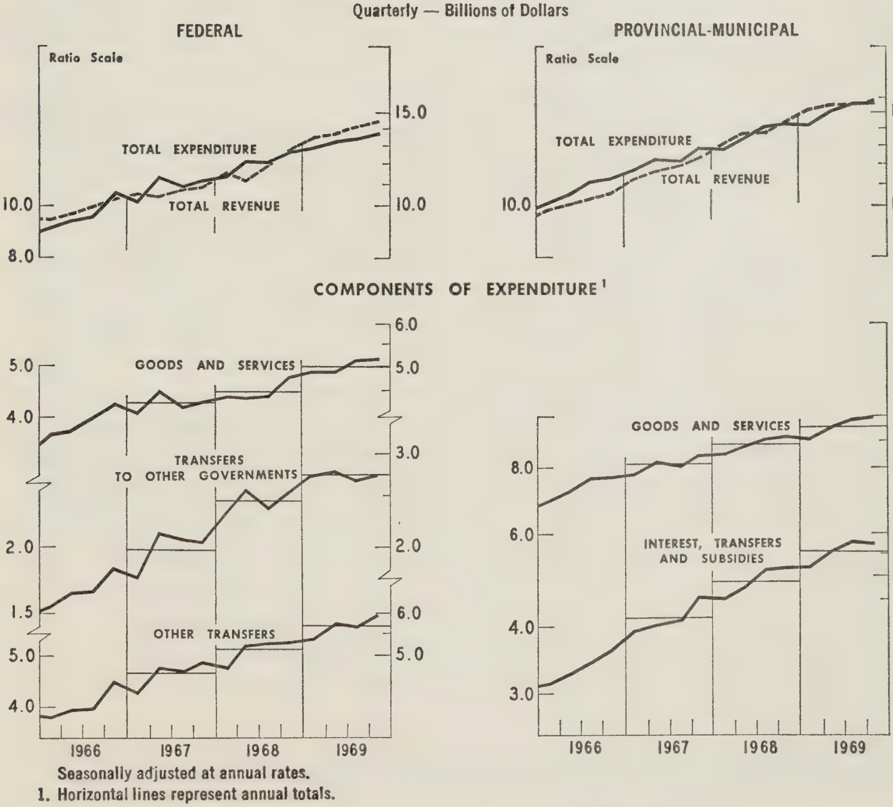
(2) Not strictly comparable with earlier data since one of the Quebec savings banks became a chartered bank in November 1969.

(3) Includes credit extended by department stores, furniture and appliance dealers, motor vehicle dealers, other retail dealers and oil company credit cards.

GOVERNMENT SECTOR. Outlays on goods and services by all levels of government combined increased by over 9 per cent in 1969, a little more than in 1968. However, as in 1968, most of the increase in spending reflected higher prices rather than an increased volume of purchases. About two thirds of the 20 per cent increase in federal non-defence outlays on goods and services is accounted for by higher salary costs, including large retroactive pay adjustments in the course of the year. Defence spending was little changed from the year before. At the provincial-municipal level, outlays on goods and services increased by about 8 per cent. Higher wages and salaries together with other rising costs, particularly in construction, accounted for most of the increase. In addition, expenditures were augmented by the participation in Medicare of five additional provinces during the year.

GOVERNMENT REVENUE AND EXPENDITURE
National Accounts Basis

Quarterly — Billions of Dollars



Seasonally adjusted at annual rates.
1. Horizontal lines represent annual totals.

Transfer payments, by all levels of government combined, to persons and non-commercial institutions increased nearly as much as in 1968. The consolidated total of expenditure by all governments on the national accounts basis (which excludes substantial non-budgetary disbursements) rose by about 10½ per cent in 1969, about the same as in 1968.

Total revenues of the government sector on the national accounts basis (excluding net receipts under the Canada and Quebec Pension Plans) rose by 16 per cent compared with 13 per cent in the previous year. This was the result of further tax increases as well as the continued growth in the tax base. At the federal level, the Social Development Tax, which came into effect at the beginning of the year, was an important factor in the faster growth of revenues in 1969 and the substantial movement from a deficit of $165 million on a national accounts basis in 1968 to a surplus now estimated at close to $600 million in 1969. While rising less rapidly than in 1968, provincial-municipal revenues in 1969 again increased more than expenditures and a surplus was recorded at this level for the first time in many years, though most of it was achieved in the early part of the year. The net position of all governments combined (excluding the Canada and Quebec Pension Plans) moved on a national accounts basis from a deficit of $190 million in 1968 to a surplus approaching $1 billion in 1969.*

The swing by the federal Government to a surplus position on the national accounts basis in 1969, combined with the curtailment of its lending programmes (see Appendix Table III) and the acceleration of corporation tax payments, resulted in a cash surplus of $399 million in contrast to a deficit of over $1 billion in 1968. This enabled the Government of Canada to reduce substantially its recourse to financial markets in 1969 while increasing its cash balances. The outstanding amount of Government of Canada domestic securities (excluding those held by Government accounts) rose by $276 million during 1969 compared with an increase of over $1.1 billion in 1968. (For details of debt management operations see pages 60-63.)

At the provincial-municipal level, the improvement in the income-expenditure position slightly more than offset a rise in loans and advances to the private sector and some increase in fixed capital investment by provincially and municipally owned business enterprises. As a consequence, borrowing by provincial and municipal governments (and their enterprises) declined slightly from $2,568 million in 1968 to $2,427 million in 1969. They relied almost exclusively on foreign markets and the Canada and Quebec Pension Plan funds for new money in 1969. Net funds raised by borrowing abroad amounted to $1,056 million, while for the first time in many years the amount of new money raised in the domestic market was negligible.

* It should be noted that in national income and expenditure accounting, expenditures do not include loans and advances and other increases in financial or existing real assets; at the same time, the balance does include net receipts which arise from certain sources such as superannuation funds even though these result in increased government liabilities.

MAJOR SOURCES OF FINANCING: FEDERAL, PROVINCIAL AND MUNICIPAL GOVERNMENTS AND THEIR ENTERPRISES(1)

(millions of dollars)

	1967	1968	1969
Government of Canada			
Increase in securities outside Gov't accounts:			
— treasury bills	295	360	67
— Canadian-pay market bonds	454	709	− 115
— Canada Savings Bonds	229	40	324
Sub-total(2)	978	1,109	276
Increase (−) in Canadian dollar cash balances	298	− 60	− 675
Total(2)	1,276	1,049	− 399
Provincial and Municipal Governments			
Increase in outstanding Canadian-pay bonds:			
— purchased by Canada and Quebec Pension Plan funds	821	894	1,020e
— other Canadian dollar issues	861	423	26
Increase in loans from:			
— chartered banks	124	− 4	54
— Government of Canada (including CMHC and MDLF)	175	276	231
Increase in short-term paper outstanding	70e	80e	40e
Increase in foreign currency issues outstanding	800	899	1,056
Total provincial-municipal borrowing(3)	2,851	2,568	2,427

e: Estimate.

(1) To obtain a total of combined federal, provincial and municipal financing without double counting, loans from the Government of Canada to the provinces and municipalities would have to be eliminated, as well as changes in provincial-municipal holdings of Government of Canada securities.

(2) Excluding net new foreign currency issues of the Government of Canada which during 1967, 1968 and 1969 were −45, +266 and +14 respectively. The increase in 1968 reflected new issues sold in the United States, Italy and Germany, the proceeds of which were used to bolster official foreign exchange reserves.

(3) To the extent that we have not been able to identify purchases by provincial government accounts of provincial or municipal securities the total of provincial-municipal financing is overstated.

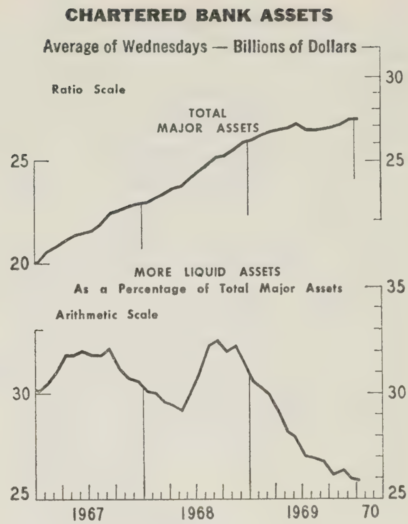
Financial Developments in Canada

GENERAL REVIEW

In an environment influenced by the continued strong demand for funds, entrenched inflationary expectations on the part of borrowers and lenders, and sharply rising interest rates abroad, monetary policy became increasingly restrictive during 1969. As a result, money became more difficult to obtain and its cost rose to very high levels. The Bank of Canada managed the cash reserves of the chartered banks in such a way as to oblige them to meet a considerable part of the strong demand for bank credit by running down their more liquid assets. The Bank also supplemented its traditional techniques of monetary control through cash management by using its power to increase the minimum secondary reserve requirement and by a number of requests to the chartered banks, as described in the opening section of this Report. The increase in total bank assets and in money supply, however defined, was much smaller in 1969 than in 1968. The implementation of monetary policy was facilitated by the improvement in the fiscal position of the Government of Canada. The elimination of the Government's need to add to the total volume of market issues outstanding made it possible for the supply arising from the reduction in the chartered banks' holdings to be absorbed by non-bank holders without putting even greater pressure on financial markets.

The financing arranged by various sectors of the economy was discussed in the previous section. Excluding the Government, the total was very substantial, particularly in the first half of the year; it is estimated to have amounted to about $9 billion in 1969 compared with $8 billion in the preceding year. By far the greater part of this increase was accounted for by the requirements of non-financial businesses. Inflationary expectations, as well as influencing the demand for credit, also had a marked impact on the form of lending. Canadian lenders appeared reluctant throughout most of the year to commit their funds on a long-term basis. In order to raise funds, borrowers shortened the average term of new security issues or in many cases provided the lender with an option between early or late redemption, and had greater recourse to security markets abroad. Businesses also increased their issues of convertible bonds, short-term paper and equities.

1. Average weekly yield on Government of Canada bonds with a maturity of 10 years or over.



Seasonally adjusted.

The tightening of United States monetary policy in 1969 and the pressure which this imposed on short-term interest rates in the Euro-dollar market had consequences for Canada. Interest rates in Canada were importantly affected even though Canadian Government guidelines had been instituted in 1968 in connection with Canada's exemption from the United States balance of payments programme with the objective of limiting the transfer of funds by Canadian investors to countries other than the United States. Canadian banks were able to place funds with banks in the United States at interest rates nearly as high as those prevailing in the Euro-dollar market. In order to shield short-term interest rates in Canada from some of the extraordinary pressures prevailing abroad, the Bank of Canada intervened at mid-year to limit the outflow of "swapped" deposits through the banking system.

BANK OF CANADA OPERATIONS

As indicated in the opening section of this Report, monetary policy again shifted towards severe restraint in the autumn of 1968. The Bank of Canada's cash reserve management was directed towards reducing the liquidity of the banking system. Short-term interest rates rose and the Bank Rate was increased from 6 per cent to 6½ per cent on December 18, 1968 and to 7 per cent effective March 3, 1969. The continued substantial demand for bank credit was met by the banks in part by running down their holdings of liquid assets.

By April 1969 the banks' more liquid assets were over $600 million less than their peak level in the final quarter of 1968 and the ratio of such assets to total major assets was under 29 per cent, a low level by earlier standards. Nonetheless, bank loans continued to increase strongly and in order to add to the pressure on the banks, the Bank of Canada announced on April 11 an increase from 7 per cent to 8 per cent in the minimum secondary reserve ratio required of the chartered banks, effective in June. The resources potentially available to the chartered banks for lending were thus reduced by a further $250 million. Although the rate of growth in bank loans declined in May and June, the banks' more liquid asset ratio fell further to a new low of 27.6 per cent in June.

On June 11 the Bank of Canada raised the Bank Rate from 7 per cent to 7½ per cent. In May and early June there had been a very rapid escalation of Euro-dollar rates to more than 12 per cent and this put strong upward pressure on short-term rates in Canada. On July 15 the Bank of Canada raised the Bank Rate to its present level of 8 per cent and at the same time asked the banks to regard the amount of their "swapped" deposits at that date as a temporary ceiling.* These deposits had risen by over $950 million from the beginning of the year; the increase between mid-April and mid-July alone was $750 million.

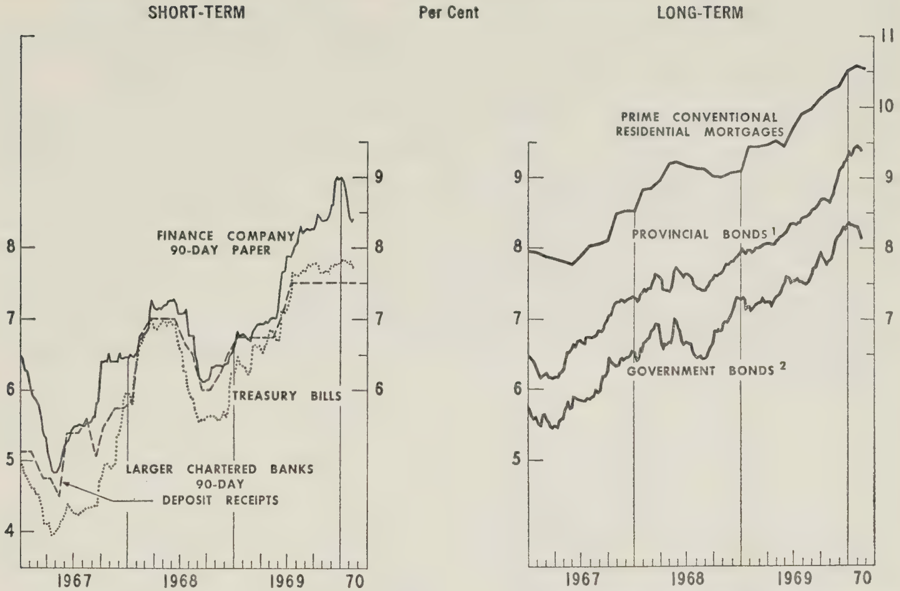
In response to requests of the Bank of Canada, the major banks agreed not to compete aggressively for large Canadian dollar term deposits, and the rate of interest paid on such deposits rose less than other short-term rates. It has remained at 7½ per cent since July and the volume of such deposits has declined considerably. By the end of July, typical short-term market yields had risen by about 1½ per cent from the end of 1968 and the rate on long-term Government of Canada securities had moved up by ¼ per cent over the same period.

During the last six months of the year the tightness of credit conditions was very apparent. Short-term interest rates rose further. The chartered banks' more liquid asset ratio continued to decline and reached a level of 25.9 per cent at year-end. Bank loans increased very little as the banks found it necessary to ration severely their available resources.

There was a marked expansion of the short-term commercial paper market as corporations sought substitutes for bank loans. Excluding paper issued by finance companies and by governments and their agencies, the amount outstanding is estimated to have risen from about $550 million in June to about $850 million in November, about double the rise in the same period of 1968. In December, typical rates offered on such paper rose sharply to reach levels in excess of 9½ per cent, over one per cent higher than at mid-year, and the amount of paper outstanding declined by about $160 million. Although the

* This measure was reinforced in January 1970 when the Bank of Canada wrote to investment dealers and trust companies asking them to co-operate by not arranging similar transactions in other ways.

INTEREST RATES



1. Average weekly yield on the 10 provincials included in the monthly series published by McLeod, Young, Weir and Co. Ltd.
2. Average weekly yield on Government of Canada bonds with a maturity of 10 years or over.

evidence of strain in this market was related in part to usual year-end liquidity demands in both domestic and foreign markets, it may also have indicated that the earlier rate of expansion was somewhat overdone.

Yields on long-term securities also rose, especially in the closing months of the year when they were influenced by similar but more pronounced movements in the United States. In the early part of 1970 there has been a moderate decline in short-term market interest rates partly because of the easing of year-end tensions and partly because of a downward movement of interest rates in the United States. Long-term rates followed a similar pattern.

Beginning in January 1969 the chartered banks were required to meet their statutory average cash reserve requirements on a half-monthly rather than a monthly basis. The new arrangement was intended to increase the predictability and the rapidity of the response of chartered banks to the cash management policy of the central bank and it has worked satisfactorily.

Reflecting the persistent pressure on the banking system the chartered banks had advances outstanding from the central bank on 35 business days in 1969 compared with 14 business days in 1968. The average amount of advances outstanding on business days was $1.2 million in 1969 compared with $0.2 million

in 1968. Over the same period securities held by the Bank under purchase and resale agreements with money market dealers were outstanding on 93 business days, compared with 35 business days in 1968 and averaged $9.4 million on a daily basis in 1969 compared with $4.3 million during the previous year.

Changes in the Bank of Canada's holdings of Government of Canada securities for each month in 1969 are summarized in Appendix Table I. There was a net increase in the Bank's portfolio over the year of $170 million, virtually all as a result of transactions with the securities market. From time to time the Bank undertook temporary swaps of foreign currency assets with the Exchange Fund Account for cash management purposes. Appendix Table II indicates the main changes in the Bank's balance sheet each month in 1969. Bank of Canada notes in circulation increased by $217 million over the course of the year.

FINANCIAL INSTITUTIONS

The major assets of the group of financial institutions shown in the table below grew by nearly 8 per cent in 1969 compared with 13 per cent in 1968. Virtually all of this slower growth was attributable to the chartered banks; the annual rate of growth of the other financial institutions as a group was about 12

MAJOR ASSETS OF SELECTED FINANCIAL INSTITUTIONS

	Millions of dollars Dec. 1969	Increase in millions of dollars		Percentage increase			
		1968	1969	Average 1963-66	1967	1968	1969
Chartered banks(1)(2)	27,503	3,258	1,285	8.3	14.2	14.2	4.9
Quebec Savings Bank(1)	522	62	36	7.3	9.0	14.6	7.4
Trust and mortgage loan companies	8,462e	780	1,019e	18.6	9.8	11.7	13.7e
Sales finance and consumer loan companies	5,269e	447	654e	11.9	6.5	10.7	14.2e
Credit unions and caisses populaires	3,900e	356	291e	14.8	15.0	10.9	8.1e
Total	45,656e	4,903	3,285e	10.8	12.5	13.1	7.8e
Total excluding chartered banks	18,153e	1,645	2,000e	15.2	9.9	11.3	12.4e

e: Estimate.

(1) For comparability the assets of the Quebec Savings Bank which became a chartered bank in November 1969 are included with chartered bank assets in each period shown.

(2) Major Canadian dollar assets plus net foreign currency assets; average of Wednesdays.

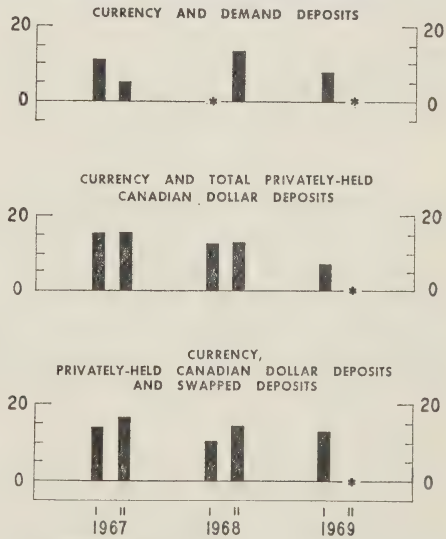
per cent in 1969 compared with about 11 per cent in the previous year. Partly as a result of the improvement in their competitive position arising from the 1967 Bank Act revision the banks grew by 14 per cent per annum in 1967 and 1968. However, their total major assets increased by only 5 per cent in 1969. In absolute terms the combined assets of all these institutions increased by $3,285 million in 1969, $1,618 million less than in 1968.

The competition for funds among financial institutions in 1969 resulted in substantially higher deposit rates. Rates offered by chartered banks on non-chequable savings deposits rose from 5 per cent in late 1968 to 6½ per cent in mid-1969 and since then have remained at that level. Rates on similar deposits at trust and mortgage loan companies followed the same pattern. The rate on large short-term deposits at the banks increased from 6½ per cent in December 1968 to 7 per cent in June and to 7½ per cent in July but as already indicated the rate on these deposits was influenced by requests made by the Bank of Canada. The banks, however, competed vigorously for large foreign currency "swapped" deposits. The rates on such three-month deposits, which had also been at 6½ per cent at the end of 1968, rose to about 8½ per cent at mid-July largely influenced by the rapid rise in Euro-dollar rates and the rates available to Canadian banks in New York. At that time the Bank of Canada requested the chartered banks to regard the level of "swapped" deposits as a ceiling. The three-month rate climbed to a peak level of over 9½ per cent by the end of December as New York rates were rising and the forward discount on the U.S. dollar was narrowing. Trust companies also bid actively for short-term deposits. Rates offered by these institutions on 90-day deposits were between 7¼ per cent and 7½ per cent at mid-year and moved up to a range of 8¼ per cent to 9 per cent at year-end.

The increase in the general public's holdings of bank deposits and other liquid claims on banks was considerably less in 1969 than in 1968. Currency and demand deposits rose by 3.9 per cent compared with 6.7 per cent in 1968. The growth in currency and total privately-held Canadian dollar deposits was 3½ per cent.

SELECTED MONETARY AGGREGATES CURRENCY AND CHARTERED BANK DEPOSITS

Half Yearly Percentage Changes at Annual Rates



Seasonally adjusted.
*Change negligible.

GENERAL PUBLIC HOLDINGS OF CERTAIN FINANCIAL ASSETS

	Millions of dollars December 1969	Percentage increase			
		Average 1963-1966	1967	1968	1969
Currency	3,279	5.9	9.8	9.2	9.7
Chartered bank demand deposits	5,924	6.1	7.2	5.3	0.9
Sub-total	9,203	6.1	8.1	6.6	3.9
Other chartered bank Canadian dollar deposits(1)	18,515	9.3	21.0	16.8	3.3
Sub-total	27,718	8.0	16.1	13.2	3.5
Chartered bank foreign currency deposits of residents					
— swapped	1,592	17.8	12.2	– 5.5	88.4
— other	1,671	23.0	27.5	13.0	40.1
Sub-total: Currency plus all chartered bank deposits shown above.	30,981	8.7	16.4	12.6	7.5
Credit unions and caisses populaires deposits	2,310e	13.5	18.0	13.7	13.7e
Quebec Savings Bank deposits(1)	494	7.1	8.7	15.1	7.9
Trust and loan company deposits	7,585e	19.2	10.4	11.9	13.9e
Short-term paper holdings of residents	2,551e	14.0	14.0	39.4	19.1e
Canada Savings Bonds	6,683	7.1	3.8	0.6	5.1
General public holdings of the above assets	50,604e	10.1	13.3	11.7	8.9e

e: Estimate.

(1) For comparability the deposits of the Quebec Savings Bank which became a chartered bank in November 1969 are included with chartered bank deposits in each period shown.

A summary of the various other types of liquid assets held by the general public is presented in the above table. The public's holdings of chartered bank foreign currency deposits (both "swapped" and other) and of deposits at credit unions and caisses populaires, and trust and loan companies showed relatively large increases in 1969, partly offsetting the slower growth in the public's holdings of Canadian dollar bank deposits.

THE CHARTERED BANKS. With an increase of only 5 per cent in their total major assets during 1969 the banks found it necessary to dispose of liquid assets on a large scale to finance a 13½ per cent increase in their loan portfolio. Holdings of liquid assets as a percentage of total major assets had risen to about

CHARTERED BANK MAJOR ASSETS AND LIABILITIES*

(average of Wednesdays — seasonally adjusted)

	Millions of dollars Dec. 1969	Increase in 1969: millions of dollars 1st half	2nd half	percentage at annual rates 1st half	2nd half	Percentage increase 1968	1969
Total major assets	27,366	1,098	255	8.4	1.9	14.2	5.2
More liquid assets	7,098	−644	−455	−15.7	−12.0	17.5	−13.4
Less liquid assets	20,262	1,689	740	18.9	7.6	12.8	13.7
of which: general loans	14,925	1,522	252	23.1	3.4	10.9	13.5
(business loans)(1)	(8,754)	(833)	(251)	(21.7)	(5.9)	(9.4)	(14.1)
(unsecured personal loans)(1)	(4,155)	(417)	(67)	(22.7)	(3.3)	(23.1)	(13.2)
loans to grain dealers	1,267	− 55	380	−11.7	85.7	49.4	34.9
residential mortgage loans(2)	1,310	151	125	29.2	21.1	24.0	26.7
(More liquid assets ratio at end of period, per cent)	(25.9)	(27.9)	(25.9)				
Total Canadian dollar deposits	25,773	1,070	195	8.7	1.5	14.3	5.1
Demand deposits	5,763	192	−137	6.7	− 4.6	5.3	0.9
Personal savings deposits	15,151	758	701	11.1	9.7	15.8	10.6
of which: chequable(2)	5,636	−332	−615	−10.1	−19.7	−13.3	−14.4
non-chequable(2)	5,663	705	618	32.5	24.5	56.4	30.5
fixed-term(2)	3,594	601	454	47.3	28.9	101.3	41.6
Non-personal term and notice deposits	3,688	−157	−636	− 7.0	−29.4	20.3	−17.6
Government of Canada deposits(2)	1,437	− 53	604	−12.0	145.0	29.7	62.2
Swapped deposits(1)(2)	1,551	717	71	187.9	9.6	−15.8	103.3
Other foreign currency deposits of residents(1)(2)	1,712	245	191	38.4	25.1	22.2	34.2

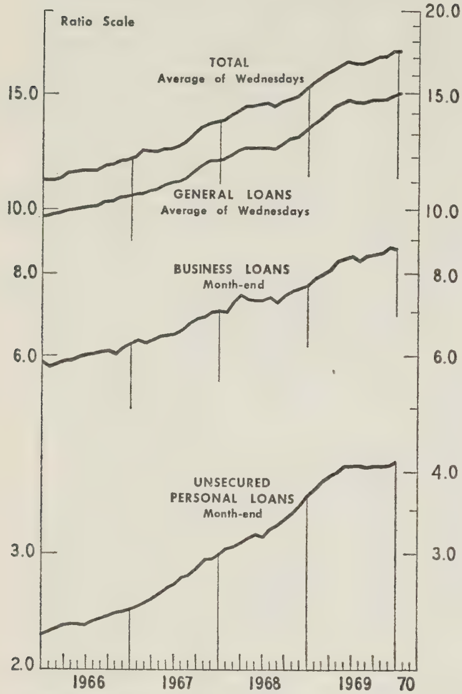
(1) Month-end figures.
(2) Not seasonally adjusted.
* Includes data as at December 31, 1969 for the Quebec Savings Bank which became a chartered bank in November 1969; excluding this bank, total major assets rose by 4.9 per cent in 1969.

32 per cent in the fourth quarter of 1968 but by the end of 1969 this ratio had declined to the historically low level of 26 per cent. Between November 1968 and December 1969 the banks reduced their holdings of more liquid assets (including net foreign assets) by about $1,195 million to $7,119 million (before seasonal adjustment). Of the December 1969 total the amount of required cash and secondary reserves was $3,768 million.

Rising rates of interest in securities markets and the difficulties of raising funds in the capital market contributed to a strong demand for business loans in

CHARTERED BANK LOANS

Average of Wednesdays — Billions of Dollars



Seasonally adjusted.

1969. Most of the increase in business loans was, however, concentrated in the first half of the year when they rose at a seasonally adjusted annual rate of 22 per cent. The rate of increase fell to 6 per cent in the second half of the year.

Consumer loans were also strong in 1969 increasing at an annual rate of nearly 23 per cent in the first half of the year. In the second half of the year, however, the rate of increase in these loans was just over 3 per cent. Residential mortgage loans continued to rise markedly in 1969 as they had the previous year. Grain loans, which include loans to the Wheat Board to finance its marketing operations and an extended advance payment programme for farmers, showed a large increase in 1969, as a result of the heavy build-up of grain stocks.

The cost of bank loans rose substantially during the first half of the year. The prime lending rate, which was 6¾ per cent in the closing months of 1968, rose to 8½ per cent by the middle of 1969 and has since remained at that level.

With the co-operation of the chartered banks the Bank of Canada initiated in November 1968 a quarterly survey of chartered bank lending rates. The survey covers all loan transactions, whereby a customer's account is credited with funds whether under existing, new or renewed authorizations. The survey specifically excludes unsecured personal loans, residential mortgage loans, day loans, call loans and loans to grain dealers. The banks selected a broadly representative sample of branches which report the details of all their loans made on three consecutive days near the middle of each quarter. A total of 125 branches have been involved and they have reported on approximately 5,000 loans each quarter.

The following table shows the average interest rate on new demand loans in the sample weighted by the dollar volume, as well as the distribution of these loans, between those made at the prime rate and those above it. The average

DISTRIBUTION OF NEW DEMAND LOANS BY INTEREST RATES CHARGED(1)

Date of survey	Prime rate	Average rate on new demand loans(2)	Percentage distribution of dollar volume: At prime	At prime plus ¼%	At prime plus ½%	At prime plus ¾%	Exceeding prime plus ¾%
1968							
Nov.	6.75%	7.15%	39	23	17	8	13
1969							
Feb.	7.00%	7.35%	45	17	17	9	12
May	7.50%	7.78%	54	11	17	9	9
Aug.	8.50%	8.79%	53	8	21	10	8
Nov.	8.50%	8.78%	60	7	16	7	10

(1) The term "new" loans in this survey is defined as any transaction whereby a customer's account is credited with funds during the three selected survey days, whether under existing or renewed authorizations.

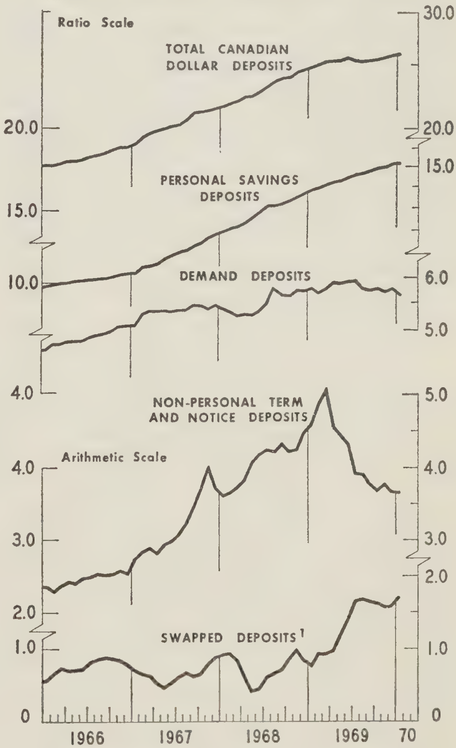
(2) Weighted by dollar volume.

rate charged on all new demand loans rose from 7.15 per cent in November 1968 to 8.79 per cent in August 1969 and remained at about that level in the November 1969 survey.

On the liability side of the banks' balance sheets only the personal savings and foreign currency deposits showed substantial increases. Within the personal savings category there was, however, a continued shift from chequable savings deposits into non-chequable and fixed-term deposits which pay higher rates of interest. Non-personal term and notice deposits declined by over $1 billion from their peak in the first quarter of 1969 as the rates paid on such deposits became less competitive. Many depositors moved their funds into "swapped" deposits and other foreign currency deposits at the chartered banks as well as into other short-term instruments.

SELECTED CHARTERED BANK LIABILITIES

Average of Wednesdays — Billions of Canadian Dollars



Seasonally adjusted.

1. Unadjusted.

TRUST AND MORTGAGE LOAN COMPANIES. The major assets of the trust and mortgage loan companies rose by nearly 14 per cent in 1969 compared with almost 12 per cent in the previous year. Net mortgage lending increased substantially reflecting the large volume of loans approved in the latter part of 1968 and throughout most of 1969. Most of the funds for mortgage lending came from the issue of fixed-term deposit-type instruments. The typical rates offered by the trust companies on five-year fixed-term certificates rose from just over 7 per cent to a range of 8½ per cent to 8¾ per cent in the course of the year.

TRUST AND MORTGAGE LOAN COMPANIES MAJOR ASSETS AND LIABILITIES

	Millions of dollars Dec. 1969e	Percentage Increase			
		Average 1963-66	1967	1968	1969e
Total major assets	8,462	18.6	9.8	11.7	13.7
Cash and short-term investments(1)	742	17.8	17.5	32.6	8.5
Federal, provincial, municipal and corporate bonds	1,532	11.2	10.6	7.2	6.4
Mortgage loans and sales agreements	5,805	22.4	9.0	10.5	17.1
Other assets	383				
Total major liabilities	7,585	19.2	10.4	11.9	13.9
Demand and savings deposits	1,709	16.1	5.5	7.2	2.1
Guaranteed investment certificates, debentures and other term deposits	5,876	20.4	12.2	13.6	17.8

e: Estimate.

(1) Short-term investments include: Government of Canada treasury bills, term deposits in chartered banks and trust and loan companies, short-term notes of sales finance companies and commercial paper.

SALES FINANCE AND CONSUMER LOAN COMPANIES. For the second consecutive year, the major assets of the sales finance and consumer loan companies grew strongly. Their business lending rose less than in 1968 but their consumer loans increased quite sharply. Very late in the year there were some signs of slackening in the rate of growth of consumer loans mainly reflecting the weakness in new car sales. Loans from parent and affiliated companies and an increase in short-term paper outstanding were the principal sources of funds to the industry during the year.

SALES FINANCE AND CONSUMER LOAN COMPANIES
MAJOR ASSETS AND LIABILITIES

	Millions of dollars Dec. 1969e	Annual percentage increase		
		1967	1968	1969e
Total major assets(1)	5,269	6.5	10.7	14.2
of which:				
Investments in securities	128	89.7	−11.8	32.0
Gross receivables	5,095	5.4	11.8	13.4
consumer receivables	3,052	2.6	9.5	15.7
business receivables	2,043	9.8	15.3	10.0
Total major liabilities	4,302	0.8	9.7	14.5
Bank loans	385	−10.7	−13.1	23.4
Short-term paper	1,559	− 0.9	33.5	18.9
Loans from parent and affiliated companies	856	− 5.0	2.3	19.7
Long-term debt, with original term of more than one year	1,502	9.1	2.5	5.8

e: Estimate.
(1) Includes receivables net of allowance for bad or doubtful accounts.

LIFE INSURANCE COMPANIES. During 1969 there were marked adjustments in the pattern of investment by the life insurance companies. The volume of net mortgage lending and new mortgage loan commitments undertaken by the life insurance companies declined quite sharply in 1969, although they provided an increased volume of funds through equity participation in new projects. Holdings of bonds changed little; but the industry substantially

SELECTED CANADIAN ASSETS OF SIXTEEN LIFE INSURANCE COMPANIES(1)

	Millions of dollars Dec. 1969e	Percentage increase			
		Average 1963-66	1967	1968	1969e
Total Canadian assets	12,308	7.1	5.6	5.9	5.0
of which:					
Federal, provincial, municipal and corporate bonds	4,122	3.2	3.4	1.8	0.5
Mortgage loans	6,224	10.0	5.4	6.3	4.2
Real estate	543	6.3	7.7	6.8	15.3
Policy loans	575	5.0	6.4	14.9	20.5
Preferred and common stocks	687	20.5	26.5	24.6	21.1

e: Estimate.
(1) Relates to the life branch assets of 16 life insurance companies whose net premium income in Canada in 1968 was 80.9 per cent of the total of all companies registered under the Federal Insurance Acts.

increased its investment in short-term paper and common stocks. There was also a continued increase in the amount of policy loans in 1969. For the year as a whole total assets (held in Canada) by the insurance companies shown in the table on page 59 grew by about 5 per cent compared with almost 6 per cent in the previous year.

SECURITIES MARKETS FINANCING

Governments and private corporations issued a total of $4.7 billion of new securities net of retirements in 1969, about $800 million less than the previous year. Net new borrowing by the Government of Canada declined by more than $1 billion while net new issues by others rose from $4.2 billion in 1968 to $4.5 billion in 1969. Among the major suppliers of funds to the new issues market only the non-bank financial institutions and non-residents increased their purchases of securities. The chartered banks' security holdings fell by $481 million during 1969, compared with a net increase of over $1 billion in 1968. Direct purchases of securities by other residents were down slightly despite the successful Canada Savings Bond campaign. The holdings of provincial and municipal securities by the Canada and Quebec Pension Plans continued to rise during 1969.

As noted earlier in the discussion of spending and financing by major sectors, there were marked shifts in borrowing and in the type of security offered by various borrowers in 1969. The details of many of these changes may be seen in the table on the following page.

GOVERNMENT OF CANADA DEBT MANAGEMENT OPERATIONS

The continued rise in the trend of the general level of interest rates in 1969 created an unsettled environment for debt management operations but the problem was eased by the much improved fiscal position of the Government of Canada and the relative stability in foreign exchange reserves.

Debt management operations in market securities were generally confined to the refunding of maturing issues in the domestic market. There were five market bond offerings totalling $1,390 million against retirements and cancellations of $1,576 million. Details are provided in the table on page 63. In addition to the offerings of three-month and six-month treasury bills at the regular weekly tenders, special bills of up to one year were issued on three occasions each connected with a refunding of maturing securities. Treasury bills outstanding rose by $70 million. The net decline in total Canadian dollar market securities was, therefore, $116 million.

NET NEW ISSUES OF SECURITIES

(millions of Canadian dollars)

	1967	1968	1969
Funds raised through new issues of:			
Government of Canada bonds and treasury bills	934	1,375	290
Provincial and municipal securities	2,552	2,296	2,142
Corporate bonds — convertible	17	64	152
— other	973	822	693
Corporate short-term paper	70	407	536
Corporate stocks	507	598	932
Total funds raised and supplied	5,053	5,562	4,745
Funds supplied by increase in holdings of:			
Bank of Canada			
— Government of Canada market issues	334	135	170
Chartered banks			
— Government of Canada market issues	740	943	– 480
— Provincial and municipal securities	84	48	– 7
— Corporate securities	45	107	6
Total chartered banks	869	1,098	– 481
Non-bank financial institutions			
— Government of Canada market issues	– 4	63	115e
— Provincial and municipal securities	143	19	– 47e
— Corporate bonds and short-term paper	274	191	266e
— Corporate stocks	90	130	253e
Total non-bank financial institutions	503	403	587e
Canada and Quebec Pension Plans			
— Provincial and municipal securities	821	894	1,020e
Other residents			
— Canada Savings Bonds	229	40	324
— Government of Canada market issues	– 253	– 68	154
— Provincial and municipal securities	683	524	109
— Corporate bonds and short-term paper	632	739	447
— Corporate stocks	369	296	422
Total other residents	1,660	1,531	1,456
Non-residents			
— Government of Canada market issues	– 112	262	7
— Provincial and municipal securities	821	811	1,067
— Corporate bonds and short-term paper	109	256	662
— Corporate stocks	48	172	257
Total non-residents	866	1,501	1,993
of which:			
U.S. investors	894	1,034	1,374
Other investors	– 28	467	619

e: Estimate.

Net redemptions of Canada Savings Bonds were heavy prior to October as yields on other instruments available to investors became more attractive, but the 1969/70 issue was very successful and the total of Canada Savings Bonds outstanding increased by $324 million.

A marked shift in the distribution of marketable Government of Canada securities outstanding occurred in response to monetary policy: chartered bank holdings fell by $480 million while resident general public holdings (including investment dealers) increased by $269 million. Bank of Canada holdings rose by $170 million.

The new Government of Canada bond issues offered were short and medium term to meet investor preferences. In March and again in September investors were offered five-year bonds with an option to extend the term through exchange into longer maturities. Advance refunding of near maturities with the Bank of Canada formed a part of three operations.

The Canada Savings Bond campaign was the major debt operation of the year. The 1969/70 Series, which was dated November 1, 1969 to mature in nine years, offers investors yields ranging from 7 per cent in the first year up to 8¼ per cent by the fourth year for an average annual yield of 8 per cent when held to maturity and carries an optional compounding feature. Many holders of outstanding series took advantage of the record rate of return to convert their holdings into the new series and, as a result, gross sales of the 1969/70 Series in the fourth quarter of 1969 amounted to $4,741 million.

SUMMARY OF DIRECT AND GUARANTEED NEW ISSUES AND RETIREMENTS GOVERNMENT OF CANADA MARKETABLE SECURITIES*

Date	Issues offered	Amount delivered (millions of dollars par value)	Term to maturity	Yield to maturity	Amount retired (millions of dollars par value)
		(Payable in Canadian dollars)			
1969					
Mar. 14					100(1)
Apr. 1	7% May 1, '70	125	1 yr. 1 mo.	7.09	
	7¼% Apr. 1, '72	235	3 yrs.	7.29	
	7¼% Apr. 1, '74(4)	125	5 yrs.	7.25	
		485			410
June 27	Treasury bills	175	308 days	7.46	150
July 1					300
July 2	7¾% July 1, '70	130	1 yr.	7.75	
	8% July 1, '78	125	9 yrs.	8.00	
	Treasury bills	20	268 days	7.50	
		275			
July 25					75(5)
Aug. 15	7¾% Oct. 1, '70	40	1 yr. 1½ mos.	7.88	
	8% Feb. 1, '73	110	3 yrs. 5½ mos.	8.00	
		150			
Sept. 15					120(6)
Oct. 1	8% Oct. 1, '70	30	1 yr.	8.00	
	8% Oct. 1, '71	45	2 yrs	8.00	
	8% Oct. 1, '74(7)	225	5 yrs.	8.00	
		300			350
Nov. 28	Treasury bills	75	364 days	8.01	75
Dec. 15	8% Dec. 15, '70	75	1 yr.	8.11	
	8% Oct. 1, '71	125	1 yr. 9½ mos.	8.14	
		200			210
Dec. 31					11(8)
		(Payable in foreign currency)			
Jan. 15	6⅞% June 1, '88(2)	16	20 yrs.	6.60	
Apr. 15					1(3)
Oct. 15					1(3)

* Excludes three-month and six-month treasury bills.

(1) Cancellation of 5% bonds due July 1, 1969 held by Securities Investment Account.

(2) Part of the June 11, 1968 U.S. $100 million issue which was delivered on January 15, 1969.

(3) Partial redemption at par of U.S. pay 5% October 15, 1987 for the Sinking Fund.

(4) Exchangeable into 7½% bond to be dated April 1, 1974 and to mature April 1, 1984.

(5) Cancellation of 5¾% bonds due October 1, 1969 held by Securities Investment Account.

(6) Includes $70 million of Canadian National Railway Company 2⅞% bonds due September 15, 1969 and cancellation of $50 million 5½% bonds due October 1, 1969 held by Securities Investment Account.

(7) Exchangeable into 8% bond maturing October 1, 1986.

(8) Cancellation by Purchase Funds of the following Canadian National Railway bonds: $3.7 million of 5½% Dec./71; $1.7 million of 5% May /77; $2.0 million of 5¾% Jan./85; $3.5 million of 5% Oct./87.

Canadian Balance of International Payments

SUMMARY

The current account deficit in Canada's balance of payments widened in 1969 despite the continued rapid growth in world trade and the slowing in the growth of domestic demand after the first quarter. Major industrial disputes in Canada substantially reduced exports through much of the year, in contrast to the situation in 1968 and early 1969 when exports were boosted by abnormal demands resulting from strikes in the United States. Other factors which adversely affected exports in 1969 were the slowing of business expansion in the United States and the depressed state of the world wheat market. Imports, on the other hand, were at a substantially higher level in 1969, although they grew very little after the first quarter of the year. There was also an appreciable increase in the net deficit arising from tourist expenditures. The outcome was an increase in the current account deficit to about $725 million from the unusually low level of $60 million in 1968. There was a small reduction in the deficit with the United States but a large decrease in the surplus with other countries, notably Britain and Japan. The financing of the deficit in 1969 was facilitated by a continued substantial inflow of long-term capital, arising mainly from the sale of Canadian bonds in the United States and Germany, and by a marked shift in Canadian investor preference in favour of Canadian over American equities. The long-term inflows were sufficient to cover both the deficit on current account and a large net outflow of short-term funds and to permit a slight increase in official international reserves in 1969.

CURRENT ACCOUNT

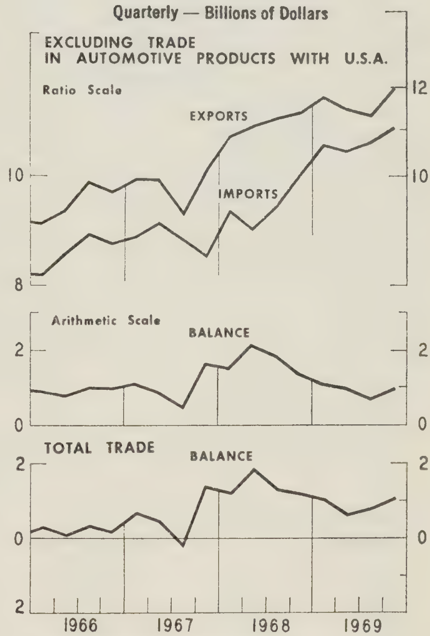
Canada's merchandise exports rose by 10 per cent from 1968 to 1969, while imports rose by 15 per cent. Rapidly rising trade in automotive products with the United States again made a substantial contribution to the growth in both exports and imports, as they have done every year since the signing of the Canadian-United States automotive agreement in 1965. Excluding this trade, exports rose by 4½ per cent compared to 13½ per cent in 1968. There was, in fact, little or no increase in the volume of these exports in 1969 since there

was an appreciable rise in prices, particularly for a number of key industrial materials. The growth in exports was depressed in the second and third quarters of 1969, mainly by strike disruptions and declining wheat sales, but was resumed in the final quarter.

Labour disputes have distorted the pattern of our trade, particularly with the United States, over much of the past two years. United States demand for Canadian copper, aluminum, iron and steel was boosted in late 1967 and the first half of 1968 by strikes or the threat of strikes in that country. In early 1969 some United States demand for imports was probably diverted to Canada because of dock strikes in the United States. During the last three quarters of 1969 strikes of varying duration in Canada sharply reduced exports of iron ore, steel, nickel and shipments of commodities through British Columbia ports. Partly in consequence, non-automotive exports to the United States rose by only 8 per cent in 1969 compared with a 17 per cent increase in 1968. While it is difficult to measure the effects of the strikes on trade, it does appear that the growth in exports to the United States of goods not so affected was fairly well maintained considering the slowing of the expansion in that country's economy.

MERCHANDISE TRADE

Quarterly — Billions of Dollars



Seasonally adjusted at annual rates.

Exports to overseas countries declined slightly in 1969. Shipments of wheat and flour fell by nearly 30 per cent; sales to most major markets were moderately lower, but the greatest part of the decline was in exports to the Soviet Union and to China. The recent signing of new contracts with these two countries assures some recovery in wheat shipments in 1970. Exports of commodities other than wheat rose less rapidly than in 1968. Shipments to Britain declined, although that country's total imports were higher in 1969, and sales to other overseas markets increased by 10 per cent, somewhat less rapidly than in 1968; these changes were attributable in part to the strikes. Canada's share of the market in Continental Europe appears to have been maintained, but our share of the rapidly expanding Japanese market fell.

The value of merchandise imports excluding United States automotive products increased by 14 per cent in 1969 following a 7 per cent increase in 1968.

MERCHANDISE TRADE[1]

(millions of dollars)

	1967	1968	1969
Exports			
To the United States			
Automotive products	1,544	2,410	3,265
Other products	5,733	6,706	7,235
Total	7,277	9,116	10,500
To other countries			
Wheat	776	745	536
Other products	3,285	3,677	3,850
Total	4,061	4,422	4,386
Total	11,338	13,538	14,886
Imports			
From the United States			
Automotive products	1,977	2,748	3,298
Other products	5,869	6,119	6,811
Total	7,846	8,867	10,109
From other countries			
Total	2,926	3,295	3,909
Total	10,772	12,162	14,018
Balance			
With the United States			
Automotive products	− 433	− 338	− 33
Other products	− 136	587	424
Total	− 569	249	391
With other countries			
Wheat	776	745	536
Other products	359	382	− 59
Total	1,135	1,127	477
Total	566	1,376	868

(1) Balance of payments basis.

However, much of the larger annual increase reflected the rapid growth up to the first quarter of 1969; there was little net increase thereafter, despite the continued upward movement in import prices to a fourth quarter level some 4 per cent to 5 per cent higher than a year earlier. For the year as a whole, imports from the United States rose by 11½ per cent while imports from overseas countries rose by 18½ per cent. The largest increase in total imports occurred in capital goods in response to rising business investment; there were

also substantial increases in most other categories of imports, including automobiles from overseas countries and steel during the strike in that industry. Imports were also encouraged by the scheduled reduction in tariffs under the Kennedy Round at the beginning of the year and by the accelerated reduction announced in June as an anti-inflationary measure.

The surplus on Canada's merchandise trade fell by about $500 million from 1968 to 1969. The trade balance with the United States, which had strengthened by about $800 million in 1968, improved by a further $140 million in 1969. The change in 1969 was more than accounted for by a reduction in Canada's trade deficit on automotive products. Our trade surplus with other countries, which had exceeded $1 billion a year since 1963, dropped by $650 million in 1969. Of this decline, over $200 million resulted from lower wheat shipments. The remaining $450 million was due chiefly to the large increases in imports already noted; about half of this decline was with Britain and the rest was virtually all with Japan, other Asian countries and Australia.

The deficit on non-merchandise transactions rose by about $150 million from 1968 to 1969 to nearly $1,600 million. This was more than accounted for by a large increase in the deficit on travel account from about $25 million in 1968 to $200 million in 1969. Expenditures by Canadians travelling abroad increased by 26 per cent while the expenditures of foreigners in Canada rose by only 9 per cent. The net deficit on interest and dividend account remained at about $950 million in 1969; an unusually large increase in receipts last year was large enough to match the increase in payments.

CURRENT ACCOUNT OF THE BALANCE OF PAYMENTS
(millions of dollars)

	1967	1968	1969
With the United States			
Merchandise trade balance	− 569	249	391
Non-merchandise trade balance	− 773	−1,041	−1,101
Current account balance	−1,342	− 792	− 710
With other countries			
Merchandise trade balance	1,135	1,127	477
Non-merchandise trade balance	− 292	− 395	− 489
Current account balance	843	732	− 12
of which:			
with Britain	512	478	263
OECD Europe	− 153	− 249	− 344
other countries	484	503	69
Total current account balance	− 499	− 60	− 722

As a result of these developments in merchandise and non-merchandise trade Canada's current account deficit, which had declined from $500 million in 1967 to $60 million in 1968, rose again to about $725 million in 1969. All of the increase last year was in our transactions with overseas countries, a consequence not only of the drop in the trade surplus but also of an increase in the non-merchandise deficit of $100 million. Almost all of the widening in the non-merchandise deficit was due to sharply increased Canadian tourist expenditures overseas.

CAPITAL ACCOUNT

The published estimates in the table below indicate that the net inflow of capital in long-term forms rose sufficiently in 1969 to finance a larger current account deficit and a larger net outflow of short-term capital and to provide a small increase in reserves.

FINANCING OF THE CURRENT ACCOUNT DEFICIT

(millions of dollars)

	1967	1968	1969
Current account deficit	— 499	— 60	— 722
Capital flows			
Long-term capital	1,347	1,590	2,162
Short-term capital	— 828	—1,181	—1,375
Total	519	409	787
Increase in official international reserves	20	349	65

Most of the increase in net long-term capital inflows was the result of Canadian investors switching from heavy buying of foreign securities in 1968, mainly United States common stocks, to net selling in 1969. Sales of Canadian stocks to non-residents were substantial for the year as a whole, but they were largely concentrated in the first half of the year. Foreign direct investment in Canada remained at about the 1968 level but Canadian direct investment in the United States rose appreciably.

Sales of new Canadian bond issues to non-residents were the most important channel for long-term capital inflows again in 1969. Placements of securities in Europe, chiefly bonds denominated in German marks, were large during the first three quarters of the year when considerations of both price and availability made this market attractive to Canadian borrowers, but towards the end

LONG-TERM CAPITAL FLOWS

(millions of dollars)

	1967	1968	1969
Direct investment: in Canada	691	610	625
abroad	– 125	– 135	– 255
Canadian stocks: net new issues	36	60	196
trade in outstandings	12	112	61
total	48	172	257
Canadian bonds: gross new issues	1,270	1,872	1,861
retirements	– 356	– 394	– 374
trade in outstandings	– 57	– 69	1
total	857	1,409	1,488
Foreign securities	– 432	– 468	96
All other long-term capital	308	2	– 49
Total long-term capital	1,347	1,590	2,162

of the year they dropped off. For the year as a whole, placements by borrowers other than the Government of Canada reached about $525 million, $200 million more than in 1968. During the first part of 1969 costs to some Canadian issuers of long-term bonds were lower in the United States than in Canada and Canadian borrowers raised substantial amounts in New York. Late in the year, when

GROSS NEW ISSUES OF CANADIAN BONDS SOLD TO NON-RESIDENTS

(millions of dollars)

	1967	1968	1969
To United States residents			
Government of Canada	4	94	22
Other borrowers	1,210	1,261	1,300
Total	1,214	1,355	1,322
To other non-residents			
Government of Canada	16	196	12
Other borrowers	40	321	527
Total	56	517	539
Total	1,270	1,872	1,861

costs of new borrowing in the United States market rose more rapidly than in Canada, Canadian sales declined somewhat though some borrowers still chose to borrow in the United States even at rates similar to or higher than those in Canada because funds were more readily available there.

Short-term capital outflows in 1969 were nearly $200 million larger than in 1968. Very high interest rates offered for funds placed on deposit in the United States and Europe attracted a heavy volume of short-term capital from Canada. On the other hand, yields on hedged short-term finance company paper in Canada were appreciably higher than those on comparable investments in the United States, and non-residents increased their holdings of this type of Canadian paper. The balancing item in the balance of payments statistics, which is the difference between the direct estimates of the current and capital accounts, is included with other short-term capital outflows although it may represent unidentified net current payments or unidentified long-term capital outflows; unidentified net payments to non-residents were very large in 1967 and 1968 but were much smaller in 1969.

SHORT-TERM CAPITAL FLOWS

(millions of dollars)

	1967	1968	1969
Canadian treasury bills and short-term paper........	−39	−80	248
Resident holdings of foreign bank balances and other short-term funds abroad...............	−284	−409	−1,609
All other short-term capital (including balancing item).......................	−505	−692	−14
Total short-term capital..........................	−828	−1,181	−1,375

One of the main channels for the international flow of short-term capital is the foreign currency operations of the Canadian chartered banks. The banks' net foreign currency liabilities to Canadian residents rose by over $1,000 million in 1969, mainly through a rapid build-up of "swapped" deposits in response to the very sharp rise in external interest rates; this build-up of "swapped" deposits was halted by the temporary ceiling arranged in July. The banks' foreign currency claims on non-residents, chiefly in the United States, rose by $500 million and there was a $500 million reduction in their own net foreign currency positions.

CANADIAN CHARTERED BANKS
HEAD OFFICES AND BRANCHES IN CANADA
NET CHANGES IN FOREIGN CURRENCY ASSETS AND LIABILITIES

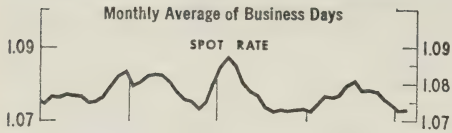
(millions of dollars)

	1967	1968	1969	Feb. 1968 to Dec. 1969
With non-residents				
United States residents				
Assets	264	137	811	1,128
Liabilities	75	−302	338	151
Net	189	438	473	977
Other non-residents				
Assets	330	624	1,401	1,893
Liabilities	153	687	1,356	2,041
Net	177	− 63	45	− 148
Total				
Assets	594	761	2,213	3,021
Liabilities	228	385	1,694	2,192
Net claims on non-residents	366	375	519	829
With Canadian residents				
Assets	−112	− 54	214	136
Liabilities	332	85	1,246	1,278
Net	−444	−139	−1,033	−1,142
Chartered banks' own net position	− 78	236	− 514	− 312

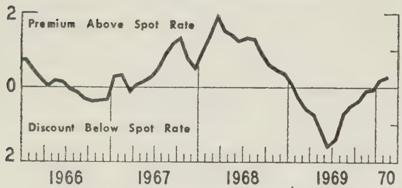
The chartered banks continued to operate under the guidelines issued in the spring of 1968 which were designed to ensure that their foreign currency operations would not provide a channel for the flow of funds from Canada or the United States to other countries. The data in the final column of the table above show that at the end of 1969 the banks had borrowed $148 million more than they had invested in overseas countries since the reference date for the guidelines, February 29, 1968.

Demand for Canadian dollars in the foreign exchange markets remained strong in 1969. The spot rate for the U.S. dollar in Canada fluctuated close to the bottom of the permitted range at the start of the year, drifted up to

U.S. DOLLAR IN CANADIAN FUNDS



90-DAY FORWARD DIFFERENTIAL[1]



1. Expressed as a per cent per annum.

the parity level in the early summer and moved down to close to the bottom of the range again by year-end. The forward exchange rate for the U.S. dollar in Canada was at a very small premium at the beginning of the year but moved to a substantial discount around mid-year. The discount on 90-day forward U.S. dollars reached a peak yield of 1.89 per cent per annum in June. Thereafter, as the spot rate on the U.S. dollar declined the forward discount narrowed and in early 1970 the forward rate was at a small premium again.

Canada's official international reserves were recently redefined by the Minister of Finance to include (in addition to gold and U.S. dollars) other convertible currencies, Canada's reserve position in the International Monetary Fund and Special Drawing Rights. On January 1, 1970 Canada received Special Drawing Rights valued at U.S. $124.3 million as its share in the first creation of SDRs and during January and February additional SDRs amounting to U.S. $8.0 million were transferred to Canada.

OFFICIAL INTERNATIONAL RESERVES

(month-ends, millions of U.S. dollars)

	Dec. 1967	Dec. 1968	Dec. 1969	Feb. 1970
Foreign currencies				
U.S. dollars	1,255.2	1,964.9	1,743.6	1,898.3
Other currencies	13.4	11.6	12.3	12.8
Gold	1,014.9	863.1	872.3	879.1
Special Drawing Rights	–	–	–	132.3
Reserve position in the IMF	433.4	206.2	478.1	501.4
Total official international reserves	2,716.9	3,045.8	3,106.3	3,423.9

APPENDIX TABLE I

BANK OF CANADA NET TRANSACTIONS IN GOVERNMENT OF CANADA SECURITIES IN 1969

(delivered basis — par value in millions of dollars)

	Net purchases from (+) or net sales to (−) investment dealers and banks						
		Bonds[1]					
	Treasury bills	3 years & under	3 years to 5	5 years to 10	Over 10 years	Sub-total bills and bonds	Securities under PRA
Jan.	− 15	− 1	–	–	–	− 16	–
Feb.	−106	–	–	–	–	−106	–
Mar.	+ 6	–	–	–	–	+ 6	–
Apr.	+ 26	+ 54	−37	–	–	+ 43	–
May	− 48	+ 40	+19	+11	–	+ 23	–
June	+ 14	+ 8	–	–	–	+ 21	+32
July	+ 40	+ 22	–	−11	–	+ 51	−27
Aug.	–	+ 9	–	− 3	–	+ 6	− 5
Sept.	+ 49	–	–	–	–	+ 49	–
Oct.	+ 26	− 12	+ 2	–	–	+ 16	+38
Nov.	+ 36	–	–	–	–	+ 36	−38
Dec.	+ 44	–	–	–	–	+ 44	+37
Total	+ 71	+120	−16	− 4	–	+172	+37

(1) Classified by years to maturity at time of transaction.

Net transactions with Government and other client accounts						Net change in holdings of Government of Canada securities		
Purchases (+) of new issues less matured holdings		Net purchases from (+) or net sales to (−)						
		Securities investment acct.		Other Government and client accounts				
bills	bonds	bills	bonds	bills	bonds	bills	bonds	total
+ 49	− 2	−20	–	− 48	− 2	− 33	− 6	− 39
+ 34	–	+20	− 40	− 25	− 1	− 77	− 41	−117
+ 26	–	–	+ 40	− 22	− 1	+ 9	+ 39	+ 48
+ 56	+ 99	–	− 75	− 29	− 5	+ 53	+ 36	+ 88
− 19	–	–	–	− 45	− 3	−112	+ 67	− 45
+ 19	–	–	–	− 43	− 3	+ 15	+ 11	+ 25
+ 74	− 20	–	–	− 30	−14	+ 60	− 26	+ 34
+ 35	+ 75	–	− 75	− 32	− 1	+ 2	+ 1	+ 3
+ 9	–	–	–	− 25	− 2	+ 33	− 2	+ 31
− 77	+ 11	–	–	− 37	− 4	− 57	+ 4	− 53
+102	–	–	–	− 48	− 3	+ 58	− 10	+ 49
+ 44	+ 48	–	–	− 24	− 4	+ 76	+ 69	+145
+351	+212	–	−150	−407	−43	+ 27	+144	+170

BANK OF CANADA ASSETS AND LIABILITIES

(monthly changes — millions of dollars)

	Government of Canada securities at book value	Net foreign currency assets	Investment in IDB	All other assets (net)	Note circulation	Canadian dollar deposit liabilities		
						Chartered banks	Government of Canada	Other
1969								
Jan.......	− 37	− 3	+ 4	− 43	−230	−13	+158	+ 6
Feb.......	−116	-	+ 2	+ 15	− 4	− 1	− 86	− 8
Mar.......	+ 49	-	-	−112	+ 57	−65	− 53	− 1
Apr.......	+ 89	+21	+ 8	+ 35	+ 59	+33	+ 61	− 1
May......	− 44	+32	+ 1	+ 63	+ 28	+39	− 34	+20
June......	+ 24	+55	+ 4	− 10	+113	−13	− 20	− 7
July......	+ 34	− 1	+ 4	− 21	+ 26	−21	+ 21	− 9
Aug.......	+ 4	− 1	+ 3	+ 13	− 18	+46	− 9	-
Sept......	+ 32	− 7	+ 1	− 30	− 17	−26	+ 39	− 1
Oct.......	− 52	−23	+12	+ 59	− 9	+23	− 21	+ 4
Nov.......	+ 45	−41	+ 3	− 76	+ 29	-	− 93	− 4
Dec.......	+144	+25	+ 6	+ 75	+182	− 8	+72	+ 3
Total...	+173	+59	+49	− 32	+217	− 6	+ 33	+ 4

APPENDIX TABLE III

GOVERNMENT OF CANADA FINANCIAL ACCOUNTS

(millions of dollars)

	Calendar 1967	Calendar 1968	Calendar 1969
1. Budgetary surplus (—) or deficit	678	732	—609
Adjustments for national accounts basis:			
Funds borrowed (—) from:			
Public service superannuation accounts	—432	—508	—591
Unemployment insurance and old age security funds	—119	— 87	—131
All other adjustments to national accounts basis (net)	129	28	731e
2. National accounts basis surplus (—) or deficit	256	165	—600e
3. Increase in major loans and advances to:			
Central Mortgage and Housing Corporation	678	394	468
Farm Credit Corporation	168	131	96
CNR (incl. Air Canada, excl. debt refunding)	124	130	116
Export Development Corporation	28	42	35
Municipal Development and Loan Fund	66	7	— 7
Veterans' Land Act Fund	60	51	55
1967 World Exhibition (incl. guaranteed notes)	68	8	–
National governments	— 13	61	37
Provincial governments	10	61	23
Other	46	46	40
Sub-total	1,235	931	863
4. Canadian dollars required to finance increase in Government's foreign currency assets (or reduction in liabilities):			
Advances to the Exchange Fund	147	529	—207
Holdings of IBRD and Columbia River Treaty bonds	— 12	— 78	— 32
Subscriptions and advances to international agencies	19	30	30
Foreign-pay securities (outside Gov't accounts)	45	—266	— 14
Demand notes payable to international agencies	2	—229	229
Sub-total	201	— 14	6
5. Funds required for net increase in other assets or reduction in other liabilities(1):			
Refundable corporation tax	—106	82	110
Excess of accrued corporation income tax over collections(2)	—175	56	—759
All other assets and liabilities	—135	—171	— 19e
Sub-total	—416	— 33	—668e
6. Total Canadian dollar financing requirements (sum of items 2, 3, 4 and 5)	1,276	1,049	—399
7. Total Canadian dollar financing requirements were met by:			
Increase (+) in Canadian dollar securities outside Government accounts	978	1,109	276
Reduction (+) in Canadian dollar cash balances	298	— 60	—675
Total (= Item 6)	1,276	1,049	—399

e: Estimate.

(1) Apart from those shown in Item 7.

(2) A contra amount is included in "All other adjustments to national accounts basis (net)" shown in Item 1.

BANK OF CANADA STATEMENT OF INCOME AND EXPENSES

(thousands of dollars)

	1969	1968
Income		
On investments (including deposits)	247,223	203,323
All other income	227	179
Total income	247,450	203,502
Operating Expenses		
Salaries(1)	6,899	6,297
Bank contributions to pension and insurance funds	715	542
Other staff expenses(2)	469	427
Directors' fees	27	30
Auditors' fees and expenses	104	85
Taxes (municipal and business)	1,377	1,306
RCMP guards and electric protection	265	225
Bank note costs	5,043	4,939
Data processing and computer costs	425	344
Other equipment and premises (net)	979	706
Printing of publications	125	107
Other printing and stationery	265	292
Postage and express	269	259
Telephones and telegrams	246	219
Travel and transfer expense	247	206
Interest paid on unclaimed balances	75	68
All other expenses	270	297
Total operating expenses	17,800	16,349
Depreciation on Buildings and Equipment	915	998
Net Income Paid to Receiver General for Canada	228,735	186,155
	247,450	203,502

(1) The number of staff averaged 1,065 in 1969 and 1,045 in 1968.
(2) Includes overtime pay, medical services and cafeteria expense.

ASSETS

	1969	1968
Deposits payable in foreign currencies		
Pounds sterling and U.S.A. dollars	$ 79,134,263	$ 95,765,052
Other currencies	246,712	156,521
	79,380,975	95,921,573
Cheques on other banks	88,924,104	152,236,827
Advances to chartered and savings banks	900,000	5,000,000
Accrued interest on investments	60,416,497	50,940,327
Bills bought in open market, not including treasury bills, at cost	2,580,060	–
Investments — at amortized values		
Treasury bills of Canada	477,687,278	453,368,678
Other securities issued or guaranteed by Canada maturing within three years	1,929,645,504	1,540,915,405
Other securities issued or guaranteed by Canada not maturing within three years	1,650,476,290	1,890,338,307
Debentures issued by Industrial Development Bank — Note	351,344,159	305,041,830
Securities issued by the United Kingdom and the United States of America	81,232,760	10,752,213
	4,490,385,991	4,200,416,433
Industrial Development Bank		
Total issued share capital at cost — Note	52,000,000	49,000,000
Bank premises		
Land, buildings and equipment Cost less accumulated depreciation	24,152,007	22,150,087
Net balance of Government of Canada collections and payments in process of settlement	88,164,836	58,183,461
Other assets	1,401,355	1,716,238
	$4,888,305,825	$4,635,564,946

Note: The audited financial statements of the Industrial Development Bank as of September 30, 1969 show an equity of $71,740,093 at which date the Bank of Canada's investment was $51,000,000.

L. RASMINSKY, Governor
Ottawa, January 26, 1970

A. J. NORTON, Chief Accountant

AS AT DECEMBER 31, 1969
(with comparative figures as at December 31, 1968)

LIABILITIES

	1969	1968
Capital paid up	$ 5,000,000	$ 5,000,000
Rest fund	25,000,000	25,000,000
Notes in circulation	3,446,175,525	3,229,211,295
Deposits		
Government of Canada	80,930,542	47,447,900
Chartered banks	1,108,815,234	1,114,326,553
Other	42,030,347	38,380,403
	1,231,776,123	1,200,154,856
Liabilities payable in foreign currencies		
To Government of Canada	22,688,142	26,983,626
To others	953,270	1,301,224
	23,641,412	28,284,850
Bank of Canada cheques outstanding	155,021,597	146,459,854
Other liabilities	1,691,168	1,454,091
	$4,888,305,825	$4,635,564,946

Auditors' Report • We have examined the statement of assets and liabilities of the Bank of Canada as at December 31, 1969. Our examination included a general review of the accounting procedures and such tests of accounting records and other supporting evidence as we considered necessary in the circumstances. In our opinion the accompanying statement of assets and liabilities presents fairly the financial position of the Bank as at December 31, 1969.

JACQUES RENÉ DE COTRET, C.A.
of René de Cotret & Cie.

T. C. KINNEAR, F.C.A.
of Price Waterhouse & Co.

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R. F. Hirsch, *Auditor*
A. J. Norton, *Chief Accountant*

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BANK OF CANADA

ANNUAL REPORT OF THE GOVERNOR TO THE MINISTER OF FINANCE

AND STATEMENT OF ACCOUNTS

FOR THE YEAR 1970

BANK OF CANADA *Ottawa 4*

February 28th, 1971.

The Hon. E. J. Benson, P. C.,
Minister of Finance,
Ottawa, Ontario.

Dear Sir,

In accordance with the provisions of the Bank of Canada Act I am transmitting herewith my report for the year 1970 and a statement of the Bank's accounts for this period which is signed and certified in the manner prescribed in the by-laws of the Bank.

Yours very truly,

L. Rasminsky

Governor

BANK OF CANADA

Report of the Governor — 1970

Some Highlights of the Year

In the year 1970 a considerable measure of success was achieved in moderating the rise in prices in Canada, but the increase in employment and output fell well short of our potential. On the external side, the year was marked by continued inflation in overseas countries and the United States, a major increase in our external trade surplus, rapidly declining interest rates in most international financial markets, a large increase in Canada's foreign exchange reserves, and a rise in the value of the Canadian dollar in the exchange market. These internal and external developments all had important consequences for the conduct of monetary policy in Canada.

Total output continued to grow in Canada, in contrast to the situation in the United States where there was no growth in 1970, but the pace of growth was too slow to provide enough jobs for the expanding labour force. Though output increased by some 3 per cent in the course of 1970 and employment by some 2 per cent, the seasonally adjusted unemployment rate rose from about 5 per cent at the end of 1969 to about 6¾ per cent by the end of the summer. During the last quarter of 1970 and the early months of 1971 there were distinct signs of an acceleration in the underlying rate of growth of the economy and the seasonally adjusted unemployment rate fell to 6.2 per cent in January of this year. The impact of winter on economic activity resulted in a seasonal rise in the actual number of people unemployed, which reached 668 thousand in January 1971. This level of unemployment has caused deep and universal concern and the situation has been particularly worrying in parts of the country which chronically suffer from relatively high unemployment rates.

From the end of 1969 to the end of 1970 the Consumer Price Index rose by 1½ per cent compared with an average of more than 4¼ per cent in the three previous years; excluding food, where there were some special and perhaps temporary price declines, the increase in prices in 1970 was about 3½ per cent, a more modest but still significant improvement. In general our record was better in this respect than that of other industrial countries, including the United States where the rise in consumer prices was 5½ per cent. However, underlying cost factors, particularly wage and salary increases greatly in excess of productivity gains, continue to pose a threat to the durability of this achievement.

The major adjustments in Canada's external position are referred to in greater detail below. In particular, there was a sudden swing from a large deficit to a large surplus on current account, and an exchange inflow of a magnitude that became progressively harder to deal with. The rise in the value of the Canadian dollar that followed the temporary abandonment of its fixed parity contributed to the moderation of price increases but had a severe impact on the export sector of Canadian industry and on those industries which compete with imports.

MONETARY POLICY

Monetary policy was relaxed substantially in 1970. During the first quarter of the year, the Bank of Canada shifted the main thrust of its operations away from maintaining the tight credit conditions that had been directed towards helping to control inflation and brought about a progressive easing of credit conditions. This change in monetary policy, which expressed itself in the course of the year in a marked reduction of interest rates and the easier availability of credit, was responsive to developments both at home and abroad. It was accompanied by a similar shift in the direction of fiscal policy.

In Canada, aggregate demand pressure in the economy had lessened by the early part of 1970 to the point where it was reasonable to expect that inflation would subside. The amount of slack in the economy was increasing and the price performance was beginning to improve. There was no immediate evidence of better cost performance but the Bank of Canada had to take into account the time lags involved before changes in monetary policy would have their impact on the economy. The change in monetary policy early in 1970 was based on the view that, while more expansionary policies were encouraging a more rapid growth of output and employment, the change in market conditions would continue to exert a moderating influence on prices and costs.

The extent and the timing of the change in monetary policy were also influenced in important measure by the strengthening of Canada's international payments position. The rapid shift of the current account to a position of substantial surplus removed the need which had existed for many years to maintain interest rate levels high enough to attract a net inflow of capital to cover the current account deficit. Indeed, with the sharp buildup in exchange reserves that occurred in the early part of the year it became desirable to try to avoid interest rates that provided an incentive for inflows of funds. An important related factor contributing to the easing of credit conditions in Canada was the declining trend of interest rates in the United States and in the Euro-dollar market which got underway at the beginning of 1970.

As was noted above, the strength of the balance-of-payments position and the consequent rapid increase in the exchange reserves in the first five months of the year led to the decision of the Government at the end of May to cease, for the time being, purchasing enough U.S. dollars to keep the exchange rate of the Canadian dollar in the market from exceeding its parity limits, and the Canadian dollar appreciated. In view of the continued undesirability of a large inflow of capital, both the Minister of Finance and the Bank of Canada attempted to reinforce the effect of declining interest rates in Canada by asking Canadian borrowers to explore very carefully the possibilities of doing their necessary financing in Canadian markets before they had recourse to borrowing abroad. Since the first quarter of 1970 the use of external markets has fallen to a low level and this has been a helpful development.

During 1970, beginning with the March budget, fiscal policy shifted to become strongly expansionary, and this shift, as well as the addition to exchange reserves, had important consequences on the monetary situation. Budgetary and non-budgetary changes in the course of the year, together with the amount of $1.6 billion required over the year to finance the substantial addition to exchange reserves, led to a sharp increase in the cash requirements of the Government and a consequent expansion in the amount of Government borrowing. The total increase in 1970 in the amount of Canadian dollar Government securities held outside Government accounts was $2 billion; $700 million was raised through Canada Savings Bonds and the remainder, $1.3 billion, through market issues.

This large increase in the amount of Government securities outstanding was a major factor in the increase in chartered bank liquidity: the banks' holdings of such securities rose by $1.5 billion over the year, and their total Canadian liquid assets grew by $1.8 billion. This provides a good example of the important influence on monetary developments of the fiscal position of the Government and the foreign exchange position. Although the central bank has the power, through its management of the cash reserves, to control the capacity of the banking system to acquire and hold Government securities, it cannot avoid being concerned with the magnitude of the increases in interest rates that would be required to alter substantially the willingness of non-bank investors to hold Government securities. The reason for this concern is that such changes in interest rates have broad economic effects, including effects on the exchange market. In practice, there tends to be a significant relationship between large changes in the outstanding supply of Government market issues and changes in chartered bank holdings and thus in chartered bank liquidity. In the circumstances of 1970, the large increase in bank liquidity resulting from the expansion of the public debt was not inappropriate, but it follows that under different

circumstances both fiscal and monetary policy should be adjusting to the change in the situation. I return to this subject in the section which follows on the mix of financial policy.

The way in which monetary policy and credit conditions developed over the year is described in some detail in a later section on Financial Developments. Interest rates declined from the beginning of the year, at first mainly under the influence of a downward movement outside Canada. Short-term interest rates are, in general, more than 3 percentage points lower than at the beginning of 1970. The Bank Rate was reduced from 8 per cent to 6 per cent in four steps of ½ per cent between mid-May and mid-November and then to 5¼ per cent in two steps in February 1971. Over the period as a whole yields on long-term Government of Canada bonds came down 1 to 1½ percentage points. There were also substantial reductions in the cost of long-term borrowing by provinces, municipalities and corporations and, to a lesser extent, in mortgage rates.

Total bank assets rose by 9½ per cent in 1970 compared with 5 per cent in 1969. The growth of privately-held currency and Canadian dollar bank deposits of all types accelerated after the first quarter of 1970. Over the year as a whole it rose by 11 per cent compared with 3½ per cent in the previous year. This change should not be compared, as it sometimes is, with changes in the "money supply" in the United States which is normally calculated on a much narrower definition, namely privately-held currency and demand deposits; on this narrower definition, the increase in Canada in 1970 was 5½ per cent compared with 4 per cent in 1969. The liquidity of the banking system reached its low point at the end of February 1970, and rose quickly thereafter; around mid-year the chartered banks were liquid enough to become willing lenders, and personal loans increased rapidly although business loans expanded only moderately for some months. In the domestic bond market, the availability of funds increased very greatly as expectations of somewhat lower levels of long-term interest rates developed, and a remarkable volume of new long-term bond issues has been absorbed over the last six months.

THE MIX OF FINANCIAL POLICY

Since both fiscal policy and monetary policy can influence the level of total expenditure within the economy it is possible to use them in different combinations to have a given effect on total spending. But the two policies work in different ways, and alternative combinations that have an identical effect on total expenditure will have very different effects on particular sectors of the economy. This is so because, among other things, they give rise to different levels of interest rates, with differing effects on elements sensitive to interest rates such as privately-

financed housing activity, flows of capital into and out of Canada, the exchange market and the international reserves. Clearly, finding the right mix is a very important part of the task of trying to achieve simultaneously the desired performance of the economy in respect of its internal and external objectives.

A good mix of policy is not in practice easy to achieve. It is difficult to determine exactly what contribution each policy can make to the objectives sought, and what will be the time lags involved. In the shift of policy towards encouraging a higher rate of economic expansion last year, it was not possible to determine the precise portion of the job that would be done by the easing of credit and the portion to be achieved through fiscal policy. Serious difficulties arise, however, if a good balance is not maintained and it is essential that the mix of policy be reviewed as economic circumstances change. When, for example, the rate of economic growth is gathering momentum after a period of financial stimulus and the level of aggregate demand is threatening to become excessive, it is important that there be timely adjustments in fiscal policy as in monetary policy. Otherwise monetary policy might be left to choose between two unsatisfactory courses. If it allowed a large part of any continued substantial Government borrowing requirements to be accommodated through the banking system this might involve the risk of a rate of monetary expansion that could lay the foundation for future inflation. On the other hand, if it did not do so, this might involve the risk of encouraging unduly high interest rates, excessive capital inflows and upward pressure on the exchange rate.

When, as is usual, a country is maintaining a fixed exchange parity, appropriate adjustments of the mix of financial policy are clearly required to resolve conflicts that may arise between the policies needed to maintain the exchange rate and those needed for internal reasons. When the exchange rate is left free to move it might appear that the possibility of such problems is thereby eliminated. This is not so. It would be so only if the level of the exchange rate were of no consequence to the well-being of the economy, and this is clearly not the case.

The exchange rate is a very important price in a country that trades with the outside world on the scale that Canada does: changes in it have important effects on the level and nature of economic activity in Canada, particularly on the position of industries that export and that compete with imports. It is not therefore possible to ignore it, even when it floats. Public financial management must continue to be concerned that the exchange rate is broadly suitable to the development of Canada's international trade, and compatible with the desired structure of our balance of payments, in particular the size of the balance on current account. It is therefore still necessary to seek a mix of fiscal and monetary policy which encourages levels of interest rates in Canada that are consistent with the exchange rate staying within a suitable range. The

exchange rate is of course also much affected by what happens outside of Canada, and there may on occasion be severe limitations on the ability of Canadian financial policy to keep the exchange rate within a suitable range. Nevertheless, if the exchange rate moves or threatens to move outside that range it will be prudent to review the mix of financial policy in Canada to see if some other mix would be more appropriate. Whether it will be monetary policy or fiscal policy or both that will need to be changed will depend on the circumstances.

SOME PROBLEMS OF ECONOMIC POLICY

The fundamental difficulties encountered by economic policy in seeking to maintain a high and sustained rate of growth of employment and output have been dramatically demonstrated by the experience of recent years. We have seen how firmly inflationary expectations become embedded after some years of significant price rise and how much more difficult it is to deal with the problem of inflation once it gets entrenched. At the same time we have seen how painful are the temporary effects of anti-inflationary policies, in the form of the hardship suffered by those who become unemployed and in the loss of output for the whole economy.

In my opinion there was no realistic alternative to endeavouring to bring inflation under control in the interest of maximizing economic growth over the longer run. This view is not based on any single-minded dedication to price stability as an end in itself but on the conviction that without it we will not be able to attain our potential output, employment and living standards in the future.

If the price and cost performance of the economy had been more responsive to the economic climate, financial restraints could have been eased earlier and unemployment and loss of output would have been less. As it was, these restraints began to be relaxed when the pressure on resources had eased but before any real evidence of an improvement in the trend of costs had emerged. On the basis of past experience there was reason to expect that wage and salary increases would moderate as price increases moderated and as the economy operated for a time below its potential. However, significant changes have been taking place in our society and in our economic institutions, and a repetition of this historical response is not completely certain. Some risks of a resumption of price inflation are being run, and it will be necessary for economic policy to continue to be vigilant. Success in achieving our objectives depends heavily on the moderation of cost increases in Canada and of course on reasonably favourable developments abroad.

Looking at the problem of maintaining sustained growth more generally, experience in recent years has clearly revealed the dilemma confronting economic

policy in Canada. Most Canadians appear to want a relatively free economy in which a wide measure of choice in regard to their own economic decisions is possible for individuals and business, in which prices and incomes are determined not by governmental edict but by market forces and collective bargaining, and in which there is stability in the value of money. At the same time they want an economy which operates practically at full stretch all the time. In such an economy the unutilized supply of labour and productive capacity would be very scarce and the danger of inflation would be ever-present. Some margin is clearly necessary if there is to be any hope of avoiding bottlenecks and shortages that force up prices; nor is it realistic to suppose that general financial policies are capable of being so finely tuned that there will always be precisely the minimum amount of slack in the system necessary to keep inflationary pressures in check, never more and never less. Even with much greater knowledge than we now have about the impact of such general policies and of the time lags which are involved in the operation of the system, the objective of operating the economy continuously at full potential without inflation is an extremely ambitious one.

Over a period of time, a major contribution can be made to better economic performance by policies directed towards improving the quality and mobility of our resources, including our human resources; towards increasing competition and ensuring the proper functioning of markets; and towards reducing regional disparities. These policies are extremely important for the long run and should be pursued vigorously and continuously in order to strengthen the underlying structure of our economy. It is mainly to them that we must look for improvements in productivity and for the scope to utilize continuously a higher proportion of our manpower and other resources. But these policies cannot make a major difference in the short run to the balance between supply and demand in the economy. The policy options open to us to cope with recurring problems of unemployment and inflation without substantially altering the market-oriented nature of our economy are primarily those that involve the management of aggregate demand through fiscal and monetary policies.

One could theoretically conceive of using fiscal and monetary policies to keep the economy growing, but on a path so far below its potential—that is, with so much slack—that any possibility of generating inflationary pressures domestically would always be avoided. It goes without saying that an approach that relies on continuously high levels of unemployment must be rejected.

At the other end of the spectrum, the use of demand management policies in a way which encourages or tolerates continuous inflation is certainly no answer to the problem of maintaining employment over a period of time. On other occasions I have dealt at length with my reasons for this view and I need not cover that ground again in detail here. It is enough to say that as inflation

becomes entrenched in public expectations it inevitably tends to gather momentum, and the fiscal and monetary policies necessary to keep it from doing so are bound to involve at least as great a loss of real output and as much unemployment as the policies that would have been necessary to check it in the first place; and in the meantime there is the risk of inflation getting out of hand.

Between these extremes and within a market framework, we can continue to attempt to operate fiscal and monetary policies in a way which will maximize durable growth and employment while maintaining reasonable price stability. Although the results of this approach have been unsatisfactory in some periods, we should remember that our average economic performance over the couple of decades in which it has been tried has been much better than it was earlier in our history. One lesson to be learned from experience is the importance of avoiding overloading the economy in the first place; we should not set such unrealistically ambitious short-run targets for economic performance that they cannot be reached without setting in train a whole series of inflationary developments.

It is my belief that this approach to demand management can be made to work well. It does require the efficient operation of competitive markets and its chances of success will therefore be greatly improved if those who find themselves in a position, even temporarily, of being able to exercise substantial market power show reasonable restraint. Above all, if this approach is to work well it will require widespread public understanding and support.

The Prices and Incomes Commission made a serious effort to encourage restraint in the determination of prices and incomes in order to supplement fiscal and monetary policies and to mitigate some of their painful effects. Although the Commission did not obtain the widespread co-operation that it sought, I believe that it made an important contribution to the improved price performance of the economy. We must, I think, continue to promote discussion and understanding of the close inter-relationships between prices and incomes and of the potential benefits to be derived by all groups in our society from the exercise of restraint in the use of market power. Even though efforts in this direction may be slow to yield positive results, they are basic to the problem of bringing the common interest to bear on the process of price and income determination.

In the preceding paragraphs I have been discussing some broad questions of policy, taking for granted the institutional framework of a market economy. There are approaches outside this framework involving, for example, resort to direct controls on wages and prices or other fundamental changes in traditional methods of determining incomes and prices. Although a move in this direction would not eliminate the need for appropriate fiscal and monetary policies, the basic issues that arise go well beyond the economic field, and I confine myself here to the obvious comment that these alternative approaches are not without serious problems of their own.

I may note in concluding these observations that other industrial countries have the same basic problem regarding growth, employment and inflation that we have, and their experience confirms that no way has yet been found of bringing inflation under control painlessly. The problem is central to all market-oriented economies, and even countries with very authoritarian forms of government are not immune. The fact that so far most countries have not been successful in bringing the present inflation under control to a greater degree must be a matter of serious concern to us. However, this does not relieve us in Canada of the need to try to manage our affairs as well as we can. In the difficult circumstances of the past year we have been reasonably successful at reducing the rate of price inflation while at the same time some economic growth has continued. It should be our aim in 1971 to combine greater expansion of employment and output with continued moderation of prices and costs.

The International Environment

World trade continued to grow strongly in 1970. The demand for imported goods in the United States remained surprisingly high considering the relatively slow rate of growth of total income in that country, and at the same time imports by overseas countries continued to increase rapidly. However, the rate of inflation in the major industrialized countries rose and was increasingly reflected in the prices of goods entering world trade.

There was a striking degree of similarity in the trends of costs and prices in the industrialized countries in 1970 but there was a considerable difference in their rates of growth of output. The contrast was particularly marked between the United States and the overseas industrialized countries.

UNITED STATES

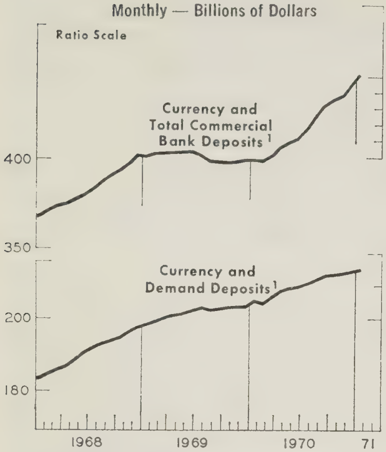
For several years the United States has been engaged in an effort to moderate cost and price inflation and to strengthen the balance of international payments. The strategy adopted early in 1969 was first to moderate the rate of growth in demand by policies of financial restraint without inducing a business recession, and then, after a period of slow economic growth and easing pressure on resources —which was expected to restore cost and price stability and to improve the international competitive position of the economy—to return gradually to full employment levels of activity.

By the beginning of 1970 it was becoming evident that a considerable moderation in demand was taking place and the restrictive stance of monetary and fiscal policy was eased. After increasing very little during the second half of 1969, currency and privately-held demand deposits (the most frequently used measure of the money supply in the United States) rose at an annual rate of 6 per cent during the first quarter of 1970 and by about 5½ per cent during the course of the year. Time deposits at commercial banks rose rapidly, especially after mid-year, and the total of currency and all privately-held commercial bank deposits rose almost 12 per cent during the year. The fiscal position of the Federal Government moved into deficit early in 1970, and was in substantial deficit for the remainder of the year.

UNITED STATES

MONEY SUPPLY

Monthly — Billions of Dollars

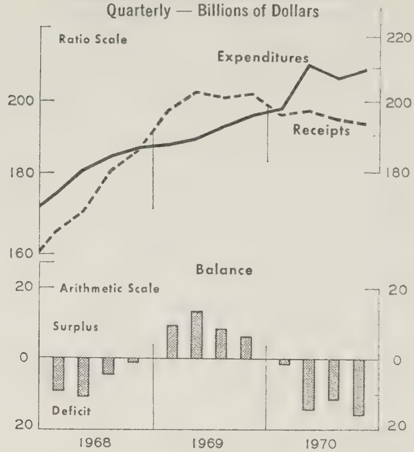


Seasonally adjusted.
1. Excludes U.S. Government deposits.

FEDERAL GOVERNMENT ACCOUNTS

National Income Accounts Basis

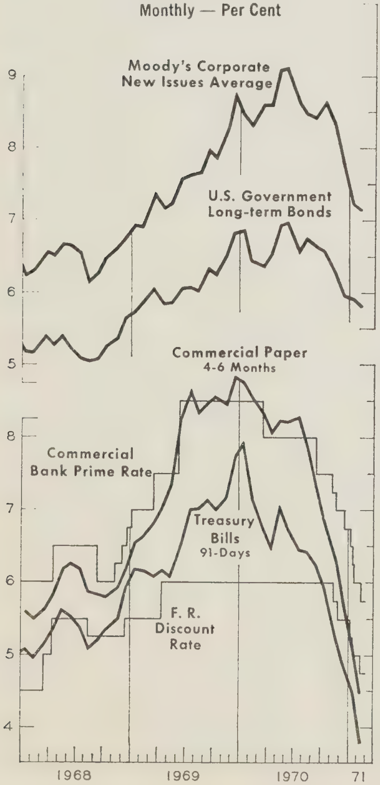
Quarterly — Billions of Dollars



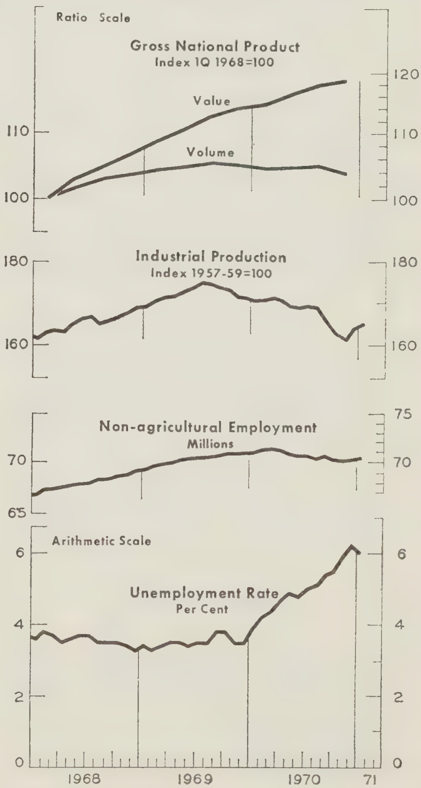
Seasonally adjusted at annual rates: fourth quarter 1970 figures preliminary.

INTEREST RATES

Monthly — Per Cent



ECONOMIC INDICATORS

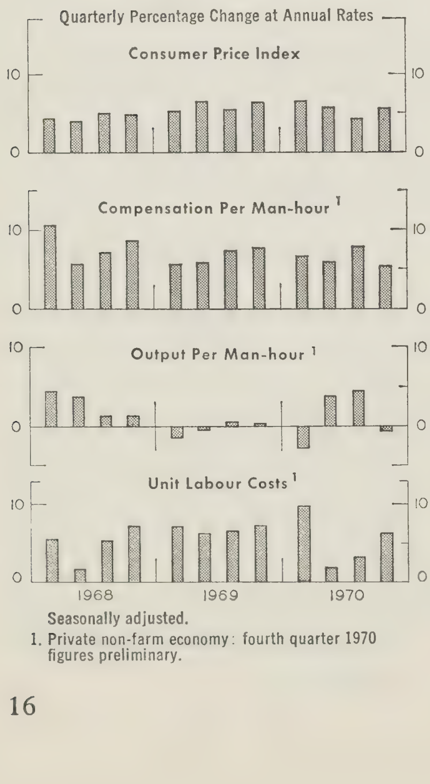


Seasonally adjusted.

As a result of the slowdown in economic growth and the resumption of monetary expansion, short-term interest rates in the United States have fallen dramatically. The yield on 91-day Treasury bills has dropped by about 4½ percentage points since the beginning of 1970, and the prime rate charged by commercial banks was lowered from 8½ per cent to 8 per cent early in the year, and since the end of the summer has fallen rapidly to 5¾ per cent in mid-February 1971. The Federal Reserve discount rate was reduced in five steps from 6 per cent early in November to 4¾ per cent in mid-February. Yields on long-term government and corporate issues remained high during most of the year, but then also moved sharply lower.

Although Gross National Expenditure increased almost 5 per cent from 1969 to 1970, the rise in prices exceeded the growth in total expenditures and in real terms output in 1970 was slightly less than in 1969. After a small decline in real GNP in the first quarter of 1970 output began to grow again as some sectors of the economy responded to the easing of financial policy. The process of recovery which seemed to have begun was, however, interrupted by a lengthy strike in the automobile industry and real output declined in the final quarter of the year. With the recovery of automobile production in December signs of renewed expansion began to appear. Industrial production rose in both December and January and the growth in personal income in this period was well above the monthly average for 1970. The seasonally adjusted unemployment rate rose to 6.2 per cent in December, but fell back to 6.0 per cent in January.

UNITED STATES
PRICES AND COSTS



Seasonally adjusted.

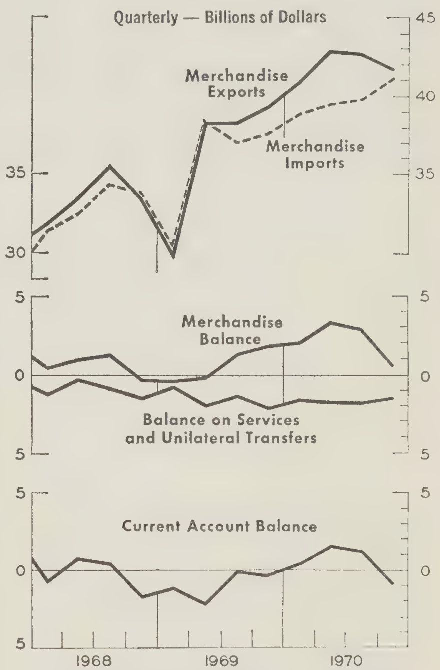
1. Private non-farm economy: fourth quarter 1970 figures preliminary.

While the United States authorities were successful in creating an economic climate which in the light of past experience should have been conducive to the restoration of relative price stability, clear indications of a significant reduction in the rate of price increase have been slow to emerge. As measured by the GNP deflator, prices increased just as much during the second half of 1970 as during the first half. However, there are signs of a slowing in some of the other broad price measures. The Consumer Price Index rose during the second half of the year at an annual rate of 5 per cent, down from nearly 6 per cent during

the previous six months. A similar comparison for the Wholesale Price Index shows a more marked decline to a 1¼ per cent rate from 3¼ per cent. Although a high rate of increase in wage rates has continued, there was a marked improvement in productivity in the second and third quarters and this gave rise to a substantial reduction in the rate of increase in labour costs per unit of output. The fourth quarter performance was adversely affected by the strike in the automobile industry.

Despite the slow growth of demand in the United States in 1970, merchandise imports rose steadily throughout the year, and by the fourth quarter were running 9½ per cent higher than a year earlier—not much less than the increase during 1969. The increase was most pronounced in manufactured goods coming mainly from western Europe and Japan. Exports rose more strongly than imports in the first half of the year, and the trade surplus increased from an annual rate of $1.8 billion in the final quarter of 1969 to $3.3 billion in the second quarter of 1970. Thereafter exports declined, due in part to the automobile strike, and the trade surplus fell to a rate of about $0.5 billion in the fourth quarter of the year. For the year as a whole the trade surplus amounted to $2.2 billion compared with $0.6 billion in 1969. It appears that there was a surplus on current account of about $½ billion in 1970 following two years of small deficits. By comparison the average current account surplus in the five years preceding 1968 was $3¾ billion.

UNITED STATES
BALANCE OF PAYMENTS
CURRENT ACCOUNT

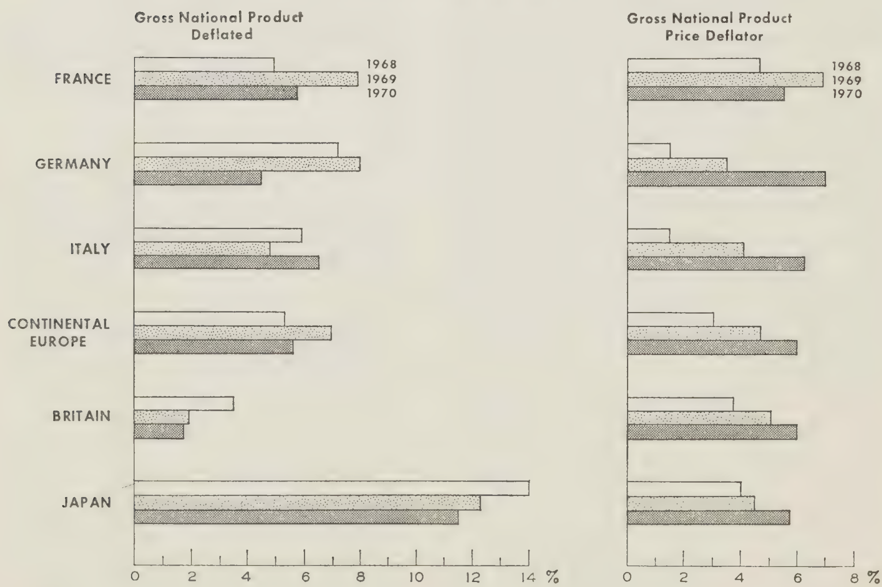


Seasonally adjusted at annual rates: fourth quarter 1970 figures preliminary.

Economic activity in *continental Europe,* already at a high level in 1968, rose rapidly through 1969 and 1970. Some easing in the rate of real growth was evident in the latter half of 1970, but it appears generally to have been due more to limitations of existing capacity than to weakness in demand.

The rate of inflation in continental Europe has been rising in recent years and it rose further in 1970. A very high level of demand has contributed greatly to the acceleration of costs and prices, wage settlements have increasingly exceeded the rise in productivity, and in some cases social unrest was an important factor, as in France in 1968 and Italy in 1969. In the latter part of 1970 the rate of increase in wages in nearly all countries was 10 per cent or more. In 1970 all countries were pursuing policies of financial restraint in order to moderate the rate of price and cost inflation. Towards the end of the year monetary policies were eased somewhat but this seems to have been motivated primarily by a desire to restrain inflows of short-term funds arising from the decline in interest rates in the United States and in the Euro-dollar market.

OVERSEAS INDUSTRIALIZED COUNTRIES
OUTPUT AND PRICES
Annual Percentage Increases



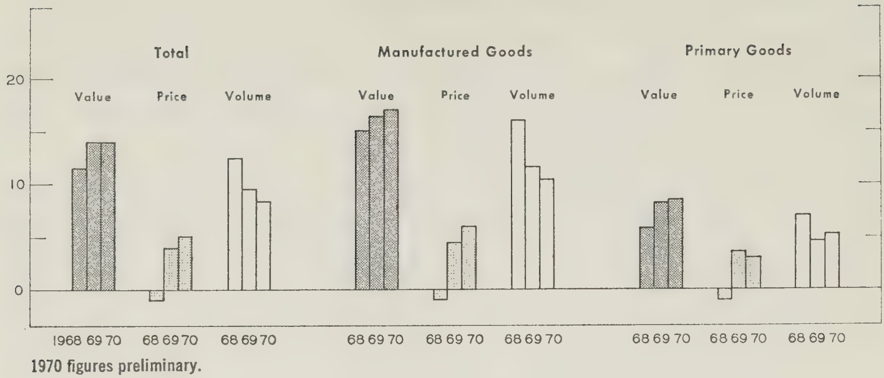
The continued high level of domestic demand in continental Europe has resulted in a weakening of the foreign trade balances of most of these countries. Total imports rose by about 18 per cent in 1970 while exports increased by 16 per cent. In France, however, since the devaluation in 1969 and the accompanying stabilization measures, the growth in imports has eased while exports have continued to increase rapidly.

For several years policies in *Britain* have been directed towards achieving a level of economic activity which would encourage a reduction in price and cost inflation and a sustainable improvement in the balance of international payments. The substantial surplus on current account which emerged in 1969 was maintained in 1970, despite a comparatively large increase in imports. During this period output grew only modestly and unemployment has been high by historical standards. Nevertheless, the rise of labour costs, though already high, accelerated appreciably during 1970, and the recent rate of increase in prices in Britain has been among the highest in the industrialized countries.

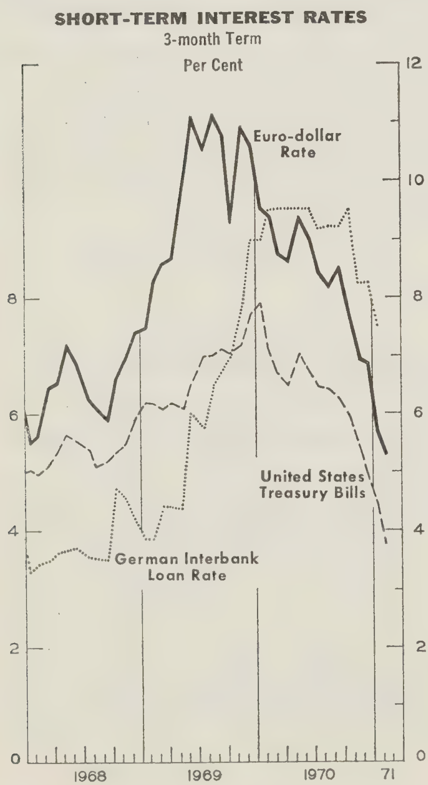
In *Japan* the economic situation at the beginning of 1970 was broadly similar to that prevailing in continental Europe. Cost and price pressures had intensified in 1969 following several years of very rapid economic expansion, and policies to restrain demand were introduced. Output continued to rise strongly in early 1970. However, the rate of increase slowed somewhat as the year progressed, and monetary policy began to ease. The rate of increase of consumer prices and wages has remained high. Japanese imports rose by about 25 per cent in 1970 and exports increased by about 20 per cent.

INTERNATIONAL TRADE AND CAPITAL FLOWS

The value of world trade appears to have risen by some 14 per cent in 1970, matching the exceptionally large increase in the previous year. The growth in the trade of industrialized countries has already been noted. Both the exports and imports of the primary-producing countries also rose sharply, stimulated by the continued high levels of demand in industrialized countries. The growth in the value of world trade has, however, been increasingly due to higher prices; in volume terms the rate of growth in 1970 was slightly less than in 1969. The price of manufactured goods entering world trade increased by about 6 per cent, a reflection of the widespread price inflation in the industrialized countries. Primary commodity prices also rose strongly in the first part of 1970, but they weakened thereafter, and over the year they rose only about half as much as did those of manufactured goods.



The pattern of international flows of long-term capital changed appreciably from 1969 to 1970. There appears to have been a further increase in the net private outflow from the United States arising from an increase in direct investment abroad and a smaller inflow of foreign capital. The net outflow from Japan also increased in 1970 as a result of a decline in borrowing abroad and larger capital exports partly attributable to special government transactions. Net outflows from Europe fell sharply, reflecting the relative tightness of credit conditions in several European countries. From Germany alone net flows of long-term capital to other countries declined from the equivalent of U.S. $6 billion in 1969 to slightly more than U.S. $1 billion in 1970. Although the Euro-bond market remained very active, borrowing by non-Europeans in this market was much reduced, and their borrowings in domestic European capital markets also fell sharply.



The direction of the main international flows of short-term funds reversed dramatically from 1969 to 1970. In 1969 U.S. monetary developments had led banks in the United States to

increase their borrowings in the Euro-dollar market by more than U.S. $8½ billion; this flow was reversed in 1970 and there were net repayments of some U.S. $6½ billion. Interest rates in the Euro-dollar market declined sharply to levels below those generally prevailing in domestic European markets and made it attractive for Europeans to borrow in the Euro-dollar market rather than in their domestic markets. These circumstances made it very difficult for European authorities to maintain the degree of monetary restraint that they considered appropriate to their economic situations. In a number of countries the authorities felt it necessary to resort to various special techniques to restrict international flows of funds in an effort to achieve some insulation from the decline in external interest rates.

INTERNATIONAL MONETARY DEVELOPMENTS

The total of international reserve assets held by national authorities rose very substantially during 1970; preliminary figures indicate an increase totalling the equivalent of almost U.S. $14 billion to about U.S. $91.5 billion, nearly 18 per cent higher than at the end of 1969. Since such holdings had changed very little during 1969 the average annual increase over the past two years was about 9 per cent, a rate which considerably exceeds the historical trend.

Although many countries added to their international reserves in 1970, a substantial part of the total increase was concentrated in a few countries. The six countries with the largest increases are shown in the table below; in total their reserve assets increased by about U.S. $12 billion, or some 50 per cent.

OFFICIAL HOLDINGS OF INTERNATIONAL RESERVE ASSETS

(at end of year in billions of U.S. dollars)

	1968	1969	1970
Germany	9.9	7.1	13.6
France	4.2	3.8	5.0
Japan	2.9	3.6	4.8
Switzerland	3.9	4.0	4.7
Canada	3.0	3.1	4.7
Netherlands	2.5	2.5	3.2
Total of above	26.4	24.1	36.0

Although the increase in Britain's holdings of reserve assets was not as great as the countries shown in the table, its net reserve position improved substantially in 1970 as a result of a reduction in its official liabilities through large repayments of amounts drawn under facilities arranged in support of sterling.

By far the largest component in the growth in international reserves in 1970 was in holdings of U.S. dollars. Two factors made important contributions to this result. One was the net transfer of dollars from United States residents to foreigners to finance the continuing large underlying deficit in the balance of international payments of the United States. The other was a large movement of dollars already owned abroad from private to official hands consequent upon the repayment of foreign borrowing by U.S. banks and the related decline in interest rates in the Euro-dollar market.

Another, though much smaller, element in the growth of international reserves during 1970 was the first creation and distribution of 3.4 billion Special Drawing Rights (SDRs) equivalent to U.S. $3.4 billion. This action resulted from the international agreement arrived at in 1969 to have the International Monetary Fund (IMF) make regular issues of SDRs in order to free the international monetary system from reliance on increases in monetary gold or foreign exchange holdings to supply its needs over time for a growth in international liquidity. Considerable experience was gained during the year in the use of SDRs; they were received or given up by eighty-two countries in settlement of international transactions. In accordance with a three-year programme the IMF issued an additional SDR 2.9 billion on January 1, 1971.

The major increase in the size of member countries' quotas in the IMF that was agreed to late in 1969 following the regular quinquennial review was largely completed in 1970. It raised the total of IMF quotas by the equivalent of U.S. $7 billion, or about 35 per cent, to U.S. $28.4 billion. The percentage increases for individual countries varied to some extent to take account of their differing rates of growth. Since countries settle their quota increases by transferring gold and domestic currency to the IMF, the recent increase in quotas has added materially to the resources available to the IMF to give financial assistance to its members when they have balance-of-payments needs.

In 1970 the Executive Directors of the IMF completed a study of the role of exchange rates in the adjustment of international payments. The Board of Governors of the IMF considered this study at its annual meeting in September and concurred in its conclusion and recommendations. After considering a variety of possible ways in which the existing exchange rate system might be modified, the study concluded that the basic principles of the fixed parity system established in Bretton Woods in 1944 were sound and should be maintained and strengthened. The report recommended the further study of three possible modifications to the present system to increase its flexibility: a slight widening of the range of fluctuations now permitted on either side of established currency parities, more prompt or more frequent adjustments of parities than have typically been made in the past, and brief transitional periods during which a currency might float while its new parity was being determined. These studies are going forward at the IMF and in other international forums.

Canadian Economic Developments

GENERAL REVIEW

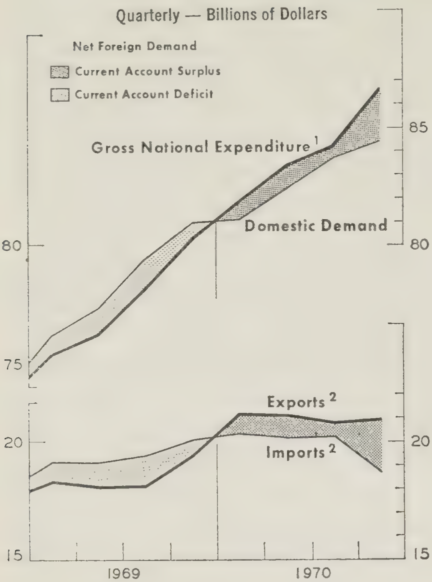
In 1970 the Canadian economy continued to adjust to the moderation of total demand which had begun to slow the pace of economic expansion early in 1969. Total output still grew—by about 3 per cent—an outcome which compares favourably either with earlier periods of adjustment in Canada or recent experience in the United States. But this was the second year in succession during which growth was insufficient to absorb all of the increase in available resources. As a consequence a substantial degree of slack developed, and unemployment rose to its highest seasonally adjusted rate since 1961. Several important industries experienced declines in output throughout much of 1970 and generally it was a poor year for profits. The considerable unevenness in the pattern of activity was accentuated at times by major strikes which severely distorted underlying trends. Before year-end, however, there were clear signs that the economy was beginning to respond to the various monetary and fiscal steps taken starting early in the year to encourage the resumption of a faster rate of expansion.

Although total employment rose by about 2 per cent in the course of 1970, the seasonally adjusted rate of unemployment rose sharply, particularly during the spring when the indirect effects of major labour disputes and the entry of an unusually large number of students into the job market were important influences. The seasonally adjusted rate apparently peaked late in the summer but fell back somewhat towards year-end and a relatively large monthly decline occurred in January 1971.

The easing in the economy was also reflected in the rate of price increase which moderated appreciably in 1970 even apart from the sizable and rather special decline which occurred in food prices. The rise in the total Consumer Price Index (CPI) over the course of the year was the smallest for any twelve-month period since 1964; excluding food, it was the best since 1966.

Wage and salary increases were disappointingly slow to respond to the easing of prices, the weakening of markets, the narrowing of profit margins and the rise in unemployment. Some moderation of the rise in costs does appear to have occurred in some parts of the economy, partly as a result of efforts to improve productivity, but high expectations with respect to increases in earnings continue to pose a threat to the durability of the better price performance.

DOMESTIC AND FOREIGN DEMAND



Seasonally adjusted.

1. Residual error excluded.

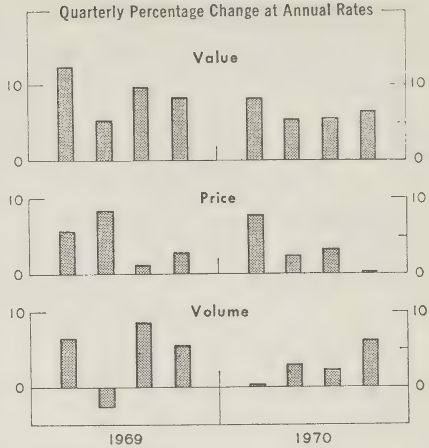
2. Goods and services.

One of the highlights of the year was the support provided to the economy by the external sector. Exports were sharply higher in 1970; the strong demand for our products abroad was reinforced by a catch-up early in the year after a series of strikes in 1969 in important export-related industries. The trend of imports during 1970 was appreciably weaker than the trend of domestic demand throughout most of the year. As a consequence, a very large external surplus developed, and this increased further towards year-end because of a pronounced weakening of imports mainly caused by strike distortions. As a result of these developments in the external sector, Gross National Expenditure (GNE) continued to grow reasonably strongly in the opening months of the year even though domestic demand did not. Domestic demand picked up in the spring but was dampened towards year-end by the three-month General Motors strike; on balance the gain in GNE in the fourth quarter, as in the first, was due primarily to the large change in the external trade position, though in the fourth quarter there was some increase in domestic demand.

The softening of domestic demand early in the year was concentrated in three areas of spending: sales of new cars, new residential construction, and business outlays on new plant and equipment. Despite major construction strikes in the spring, business investment apparently did not fall as far short of reported intentions for 1970 as initially indicated; indeed a significant increase occurred after mid-year, though investment in machinery and equipment apparently declined somewhat again in the final quarter. The moderate upturn in domestic demand in the second quarter in the face of a continued sharp decline in housing was attributable to some improvement in car sales in combination with continued support from the less volatile elements of consumption as well as from government expenditure. After mid-year, housing outlays began to recover and a strong rebound occurred in the fourth quarter. This served to offset much of the adverse impact on domestic demand of the auto strike, which resulted in a sharp drop in car sales and inventories.

Over the four quarters ending in the final quarter of 1970, GNE (GNP) in money terms increased by about 6½ per cent. The over-all price level rose by about 3½ per cent so that the rise in spending (and output) in volume terms was 3 per cent—about 2½ percentage points below the estimated average annual increase in the economy's productive potential. The preliminary national accounts for the fourth quarter and substantially revised estimates for earlier quarters, on which the foregoing comments are based, now suggest that real output grew very little in the first quarter and at an annual rate of over 6 per cent in the last quarter. An alternative measure of total output, the Index of Real Domestic Product, indicates a somewhat different pattern with more growth in the first quarter, and slightly less in subsequent quarters.* Output in the service industries continued to expand at a fairly normal rate during the year. In the goods-producing sector the mining and petroleum industries showed outstanding gains, but manufacturing, construction and agriculture experienced declines in output.

GROSS NATIONAL PRODUCT



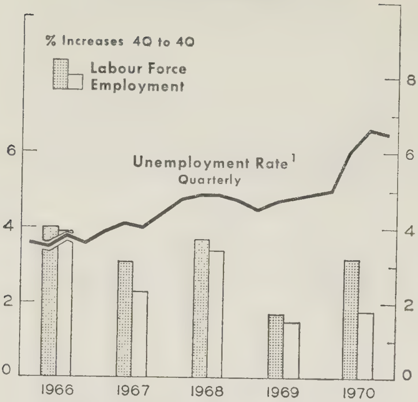
Seasonally adjusted.

LABOUR MARKET DEVELOPMENTS. The relatively slow growth of output during 1970 was matched by a modest increase in employment and this was confined to the service industries; employment in the goods-producing industries taken as a whole declined.

After a pronounced slowing during 1969 the labour force grew more rapidly in 1970 on account of a reversal of the sharp drop which had occurred in the proportion of the working age population participating in the labour force in the second half of 1969. The faster growth of the labour force, the continued relatively slow growth in employment, and the resulting rise in the unemployment rate are shown in the chart on the following page. In 1969 and also in earlier years there was evidence of some tendency for the labour force to

* Revised estimates of the Index of Real Domestic Product for 1970 show the following quarterly pattern of percentage increases at annual rates: first quarter 2.8; second quarter 1.2; third quarter 1.5; fourth quarter 4.2.

LABOUR MARKET



1. Seasonally adjusted.

accommodate itself to variations in the growth of employment but this was not apparent in 1970. The drop in participation in 1969 may have reflected a willingness of some potential workers either to leave or not to enter the job market (partly encouraged by expanded government retraining programmes) as work became harder to find. The recovery in participation which occurred in 1970 after the adjustment in the economy had persisted for some time may have reflected the growing pressure to maintain family income.

The following table shows the composition of unemployment by various groupings in the last quarter of 1970 compared with the corresponding periods of 1965 (the previous low point) and 1960 (the previous peak). It may be seen that the unemployment rate among men 25 years and over in the fourth quarter of 1970 was a full percentage point lower than the total rate, while in 1960

UNEMPLOYMENT

(fourth quarters — not seasonally adjusted)

	Thousands of persons			Per cent of labour force		
	1960	1965	1970	1960	1965	1970
Age groups						
25 years and over						
men	266	110	212	6.8	2.7	4.7
women	28	22	60	2.4	1.5	3.3
Sub-total	294	132	272	5.8	2.4	4.3
20-24 years	68	33	103	8.8	3.5	8.1
14-19 years	77	49	103	12.6	7.1	12.8
Total	439	214	478	6.8	3.0	5.7
Length of time seeking work						
3 months or less(1)	325	170	322	5.0	2.4	3.9
4-6 months	62	22	79	1.0	0.3	0.9
over 6 months	52	22	77	0.8	0.3	0.9
Total unemployed	439	214	478	6.8	3.0	5.7

(1) Includes persons on temporary layoff.

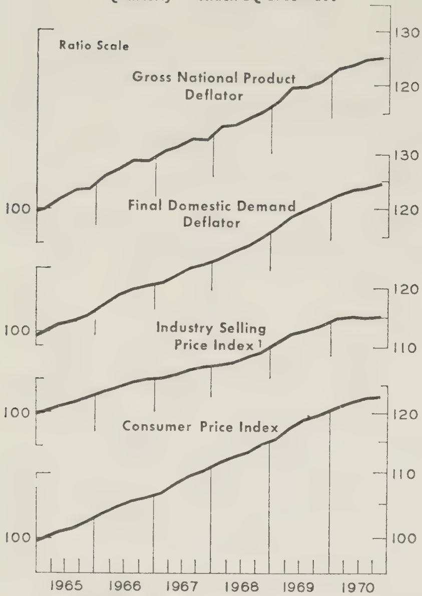
both rates were the same. Indeed, despite the growth of the labour force and the higher over-all level of unemployment, the actual number of adult males unemployed was appreciably smaller in the last quarter of 1970 than in 1960. The rate of unemployment among other groups was about as high as or higher than in 1960. This shift in the composition of unemployment probably reflects some difficulty in absorbing the larger number of young people and adult women entering the labour force. Although the total unemployment rate in late 1970 was one percentage point lower than ten years earlier, the proportion of persons unemployed for more than three months was somewhat higher in 1970.

PRICES AND INCOMES. Canada's price performance in 1970 was subject to a variety of strongly conflicting influences. On the one hand, the high rate of inflation abroad continued and, in the domestic economy, pay increases were again much in excess of productivity gains in most areas of the economy. On the other hand, the moderating influence on price increases of the easing in demand in the domestic economy was reinforced by several special or non-recurring developments. Among these the most important was the appreciation in the exchange value of the Canadian dollar after May which mitigated the impact on Canadian prices of external inflation. Domestic pricing decisions were also influenced by the undertaking of businessmen to the Prices and Incomes Commission to limit price increases in 1970 to less than would have been necessary to cover the full increase in their costs. Certain other special factors contributed to the sharp decline in food prices which occurred in 1970. The net effect of all the above influences was a distinct moderation in the rate of price increase during the year accompanied by a sharp erosion of profit margins to unusually low levels by the fourth quarter.

The rate of price increase as measured by the GNP deflator moderated significantly to 3½ per cent during 1970 from 4½ per cent over the preceding four quarters. The price component of final domestic demand, which is a better indicator of prices paid by Canadians (including as it does imports but not exports), showed a more pronounced moderation—to 3 per cent from 4¾ per cent. Improvement occurred in the case of almost all major expenditure categories, the principal exception being residential construction. A more pronounced easing in prices is evinced by prices at earlier stages in the marketing process; for example, the aggregate index of industry selling prices levelled off in 1970 following two years of rapid increase as shown in the left-hand chart on the following page.

MAJOR PRICE INDICATORS

Quarterly — Index 1Q 1965=100

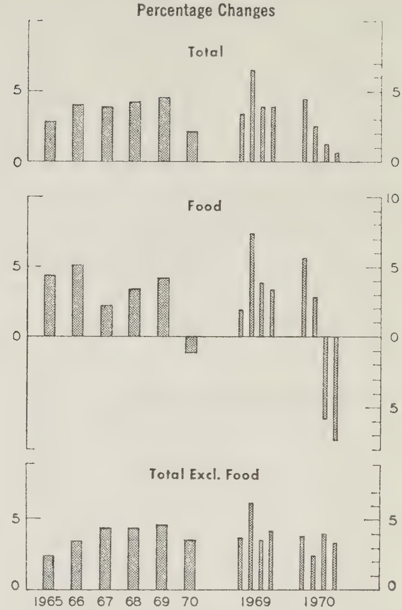


Seasonally adjusted.

1. Unofficial gross-weighted aggregation of published selling price indexes for 99 manufacturing industries.

CONSUMER PRICE INDEX

Percentage Changes



Annual changes are from 4Q to 4Q.
Quarterly changes are expressed at annual rates and are based on averages of seasonally adjusted monthly data.

There was a marked improvement in the case of consumer prices. As measured by the CPI they rose about 2 per cent from the fourth quarter of 1969 to the fourth quarter of 1970 (only 1½ per cent from December to December) compared with an increase of 4½ per cent over the previous year.

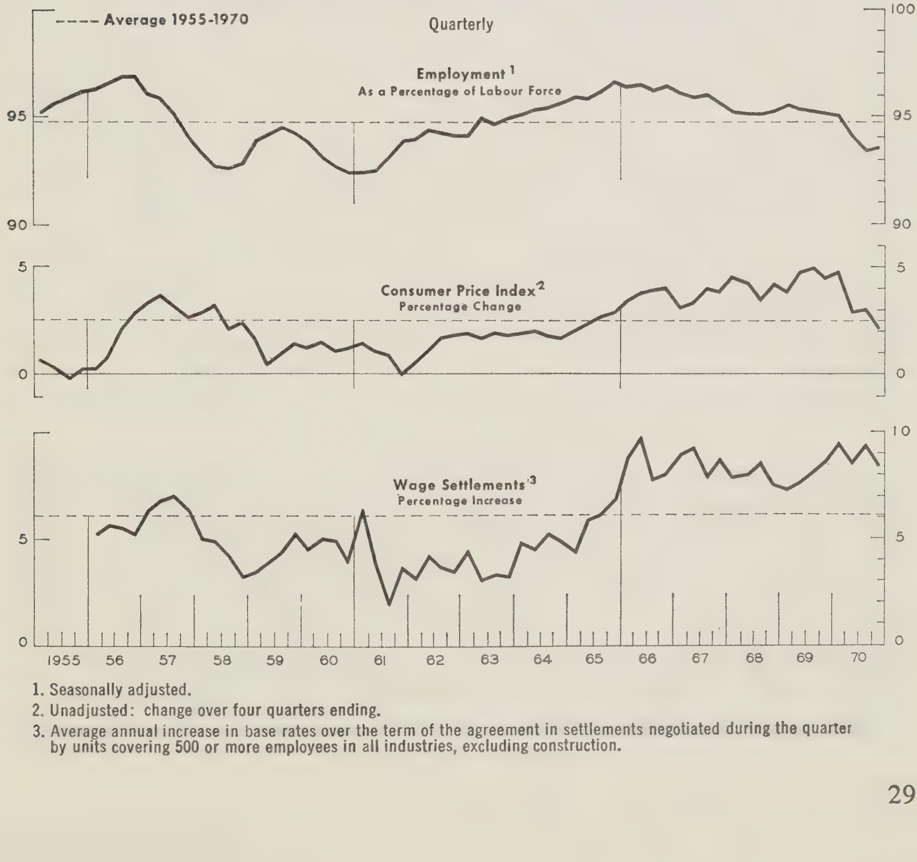
Food prices accounted for much of the improvement in consumer prices last year. They declined by 1¼ per cent during 1970 following a 4¼ per cent increase during 1969. An upswing in hog production contributed to a decline in meat prices which accelerated somewhat following the mid-year rise in the exchange rate. Though its impact is difficult to assess, the latter factor may also have influenced price trends for such items as fruits and vegetables, which have a substantial import component. Finally, competitive price discounting by the major grocery chains towards year-end so accentuated the downward trend that food prices dropped about 3 per cent in the last three months. Some of these developments are obviously transitory; in January the food index rose by ¾ of one per cent.

The moderation in other consumer prices, though less striking, was still significant. The CPI excluding food rose by 3½ per cent during 1970 compared with 4½ per cent during the preceding year. This reflected smaller

increases in prices of both goods and services other than shelter. Shelter costs again rose substantially, though slightly less than in the previous year. Despite some easing in interest rates on new mortgages last year, the average rate on mortgages in effect (the concept used in the CPI) continued to rise sharply as old contracts carrying much lower rates were renewed.

The size of negotiated wage settlements remained very high through 1970 and, from the limited information available, it is difficult to determine if there was any moderation in wage and salary increases outside the collective bargaining sector. Since year-end, there have been one or two indications of smaller wage settlements but the average increase appears to have remained virtually unchanged. In the light of earlier relationships between movements in employment, prices and wage settlements, which are shown in the following chart, a moderation in wage settlements would appear to be overdue.

EMPLOYMENT, PRICES AND WAGES



1. Seasonally adjusted.
2. Unadjusted: change over four quarters ending.
3. Average annual increase in base rates over the term of the agreement in settlements negotiated during the quarter by units covering 500 or more employees in all industries, excluding construction.

On the basis of available statistics, it is difficult to be precise about the relative movements of income per worker and output per worker. On balance, the evidence suggests little if any slowing in the rate of increase of wages and salaries per worker during 1970 but a somewhat better gain in output per worker compared with 1969. Combining these two elements, it appears that unit labour costs for the economy as a whole rose appreciably less during 1970 than in the preceding year, although this does not appear to have been the case in the manufacturing and construction industries.

The following table relates changes in various forms of income per unit of output (weighted by their relative shares) to the annual increases in the over-all GNP price index during the past five years.

AMOUNT CONTRIBUTED* TO PERCENTAGE INCREASE IN GNP PRICE DEFLATOR BY DIFFERENT TYPES OF INCOME

Type of income	Annual average 1960-65	1966	1967	1968	1969	1970
Corporate business:						
Profits before taxes	0.5	−0.2	−0.6	0.5	–	−0.9
Capital consumption allowances	–	0.1	0.3	–	0.1	0.4
Unincorporated business (non-farm)	−0.1	–	0.2	0.1	–	–
Total business	0.4	−0.1	−0.1	0.6	0.1	−0.5
Wages and salaries(1)	1.1	3.0	3.7	2.1	3.7	3.0
Farm income	–	0.8	−1.1	0.1	0.2	−0.5
Indirect taxes(2)	0.5	0.5	0.7	0.7	0.6	0.3
All other GNP components(3)	–	0.4	0.2	–	0.1	1.8
Total increase in GNP deflator	2.0	4.6	3.4	3.5	4.7	4.1

* The contributions are calculated by weighting changes in each category of income per unit of total output by its share of GNP in the base period. For example, the approximate weights used for 1970 are: total business 21; wages and salaries 56; farm income 2; indirect taxes 14; and all other GNP components 7.

(1) Includes supplementary benefits and military pay.

(2) Less subsidies.

(3) Includes non-corporate capital consumption allowances, interest and miscellaneous investment income, valuation adjustments, and the residual error of estimate.

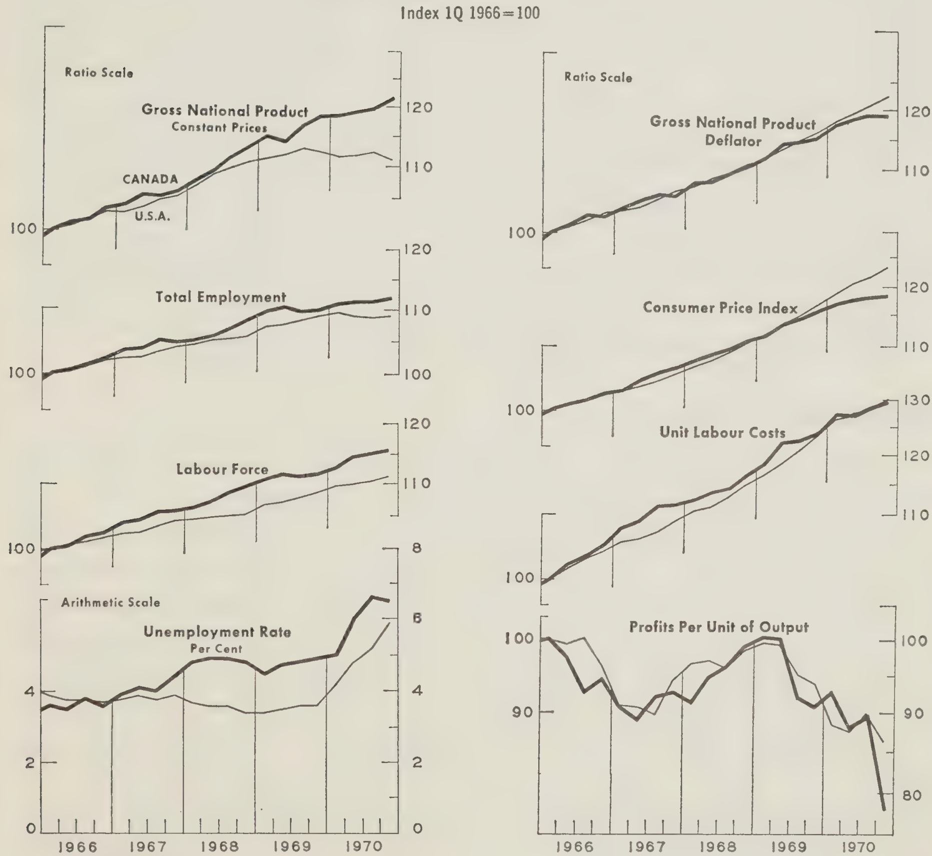
It will be noted that on an annual basis the rise in prices as measured by the GNP deflator was 4.1 per cent in 1970 as against 4.7 per cent in 1969. Wages and salaries per unit of output rose less last year than in 1969, but they again accounted for about three quarters of the over-all price increase. Business income, which had been a virtually neutral factor in the price rise in 1969, absorbed some of the impact of increases in other incomes in 1970; corporate profits were down appreciably on the year and fell particularly sharply in the fourth quarter. In addition, the decline in farm income in 1970 contributed importantly to the moderation in prices, though it was due in part to the decline in

output in that sector. There were also relatively few increases in rates of indirect taxation in 1970. The "other" components of GNP accounted for a much larger contribution in 1970; much of this was caused by the residual error in the estimates, which implies some unallocated increase in incomes per unit of output.

COMPARISON WITH THE UNITED STATES

In the recent period of adjustment economic activity has been better sustained in Canada than in the United States, though admittedly the U.S. economy in 1968 and early 1969 was operating at a higher level in relation to potential than the Canadian economy. From the first quarter of 1969 to the end of 1970,

SELECTED INDICATORS
CANADA - UNITED STATES



Seasonally adjusted.

output rose by about 6 per cent in Canada while in the United States it showed virtually no net change over this period and declined after mid-1969. However, the growth of total employment was only slightly more in Canada (implying a better over-all productivity performance in this country). The growth of civilian labour force which is normally higher in Canada was about the same in both countries with the result that the rise in unemployment rates was also similar until the closing months of 1970, though the Canadian rate started from an appreciably higher level. The two rates began to converge after September and by January 1971 they were closer together than at any time since 1967.

Price and cost performance was also better in Canada after mid-1969. The GNP price deflator averaged 5¼ per cent higher in the United States in 1970 than in 1969 compared with a corresponding rise of about 4 per cent in Canada. A somewhat smaller increase in unit labour costs in Canada after mid-1969 (despite the persistence of increases in rates of pay at least as high as in the United States) accounted for much of this difference in price performance. Another factor was the big drop in farm income in Canada which was not matched in the United States. Although corporate profits are estimated to have fallen much more sharply in the fourth quarter in Canada than in the United States, on a year-over-year basis the squeeze on profit margins was roughly comparable in the two countries. Various factors contributed to much weaker food prices in Canada and this was a major element in the strikingly smaller increase in the Consumer Price Index here. Even so, the rate of price increase for non-food items was much less in Canada. The main trends in output, labour markets, costs and prices are compared in the chart on the preceding page.

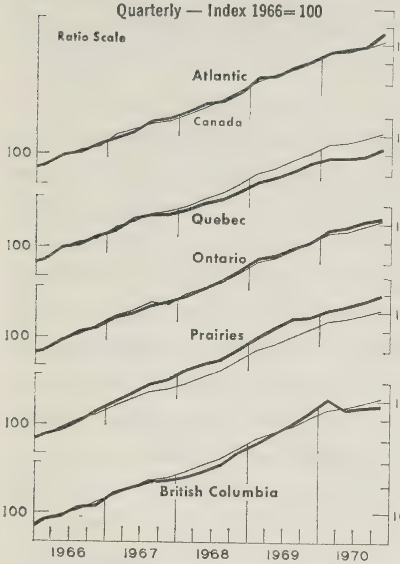
REGIONAL DEVELOPMENTS

The loss of momentum in economic growth is reflected in the relatively small increase of employment in all major regions of the country during 1970. The slowing was most pronounced in *British Columbia* where economic activity had been best maintained in 1969. Labour disputes were particularly disruptive in that province. Partly as a result of this factor, as well as weakness in the U.S. market, the important forest industries had a poor year, though there were some signs of revival in the demand for lumber late in the year as housing construction in North America recovered. Business capital investment was higher in 1970 but continued to be less buoyant than in the mid-1960s. Total employment increased only slightly over the year; on the other hand labour force growth, which has typically been very high in British Columbia (partly because of immigration from other parts of the country) was somewhat slower, but still substantial

SELECTED INDICATORS BY REGIONS

TOTAL WAGES AND SALARIES

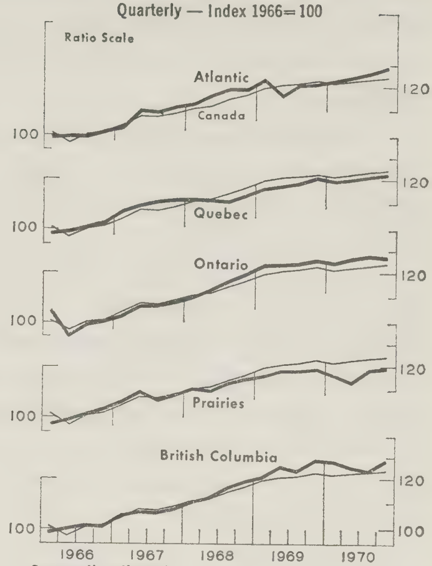
Quarterly — Index 1966=100



Seasonally adjusted.

RETAIL TRADE

Quarterly — Index 1966=100

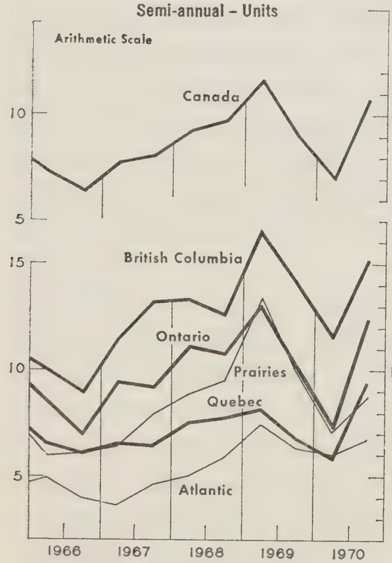


Seasonally adjusted.

HOUSING STARTS

Per Thousand Persons

Semi-annual - Units

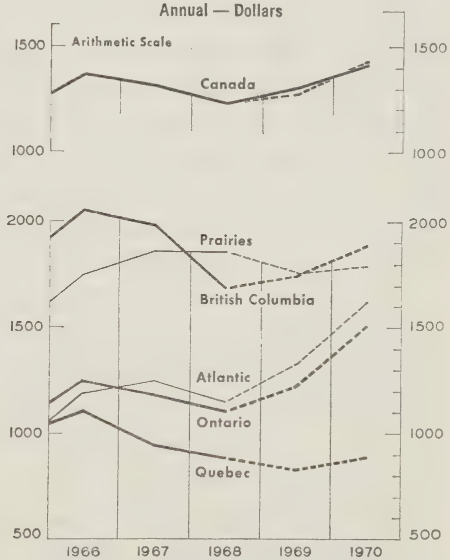


Seasonally adjusted at annual rates.

BUSINESS FIXED INVESTMENT[1] EXCL. HOUSING

Per Employee

Annual — Dollars



1. Broken lines indicate preliminary actual outlays for 1969 and mid-year intentions for 1970. Revisions for 1969 and preliminary actual outlays for 1970 are not yet available for regions.

enough to result in a pronounced rise in the unemployment rate. Indeed, the seasonally adjusted unemployment rate reached a peak of almost 10 per cent at mid-year when industrial disputes were at their height; by year-end it had declined to below 8 per cent, but it was still about 2 percentage points higher than a year earlier.

The economic situation in the *Prairie Provinces* was adversely affected by the difficulties experienced by wheat farmers in recent years and problems in some other basic industries such as potash. Employment in the region which had declined in 1969 recovered somewhat last year. In all three provinces the unemployment rate was significantly higher in 1970 than in 1969 but was still less than in other provinces. Prospects for many of the activities on which the region is dependent have recently brightened. This improvement was probably least marked in *Manitoba.* Investment intentions in that province were not much changed from a year earlier and employment in the construction industry appears to have declined appreciably. In *Alberta* the economy benefited from increased sales of oil and natural gas after mid-year, and it was apparently quite a strong year for business investment. Even so, unemployment in Alberta was also appreciably higher in 1970 than in 1969. *Saskatchewan* had been most seriously affected by the wheat and potash situations and investment intentions for 1970 were relatively weak. However, there was a notable strengthening of potash prices during 1970, and the change in the grain situation was particularly significant for Saskatchewan's position. Partly in response to the Government programme to reduce wheat stocks (LIFT) there was a drastic cut-back in prairie wheat acreage in 1970 and most of the acreage diverted was allowed to lie fallow or devoted to forage crops. As a result there was a substantial drop in the wheat crop which was only partly offset by increased oilseed and coarse grain production. At year-end the cash position of prairie grain growers was still difficult but near-term prospects had improved considerably as a result of some strengthening of export markets for wheat and feed grains.

In *Ontario,* a post-strike recovery in the mining and metals industries provided a strong lift early in 1970. However, while business capital outlays apparently rose strongly, and the normal growth of output continued in service-related industries, the pattern was more mixed and generally less favourable in secondary manufacturing; weakness was evident through much of the year in such industries as electrical goods, farm machinery, aircraft and rubber products. In the important automobile industry the prolonged strike in the last quarter had widespread repercussions. Housing starts, however, rose sharply in the final months of the year. Although employment in the fourth quarter averaged 2¾

percentage points above a year earlier, much of the increase was in the early part of the year, and with the labour force growing more rapidly, the seasonally adjusted unemployment rate went above 5 per cent around the turn of the year, compared with 3½ per cent a year earlier.

Employment in *Quebec* again rose only modestly during 1970, taking the year as a whole. At the same time labour force growth accelerated and the seasonally adjusted unemployment rate rose to nearly 9 per cent in the summer. However towards year-end, the growth in employment picked up somewhat and unemployment fell on a seasonally adjusted basis, though it remained about 1½ percentage points higher than a year earlier. A number of major Quebec industries were confronted with relatively weak markets; employment was adversely affected in such industries as aircraft, shipbuilding, electrical goods and textiles. All these factors were reflected in a slower growth of payrolls in Quebec than in other parts of the country. In addition, the relatively low level of business investment since 1966 persisted, though there may have been a slight increase over the previous year and in recent months a number of large new investment projects have been announced. A recovery of residential building in the latter part of the year was encouraged to an important extent by the CMHC low-income housing programme.

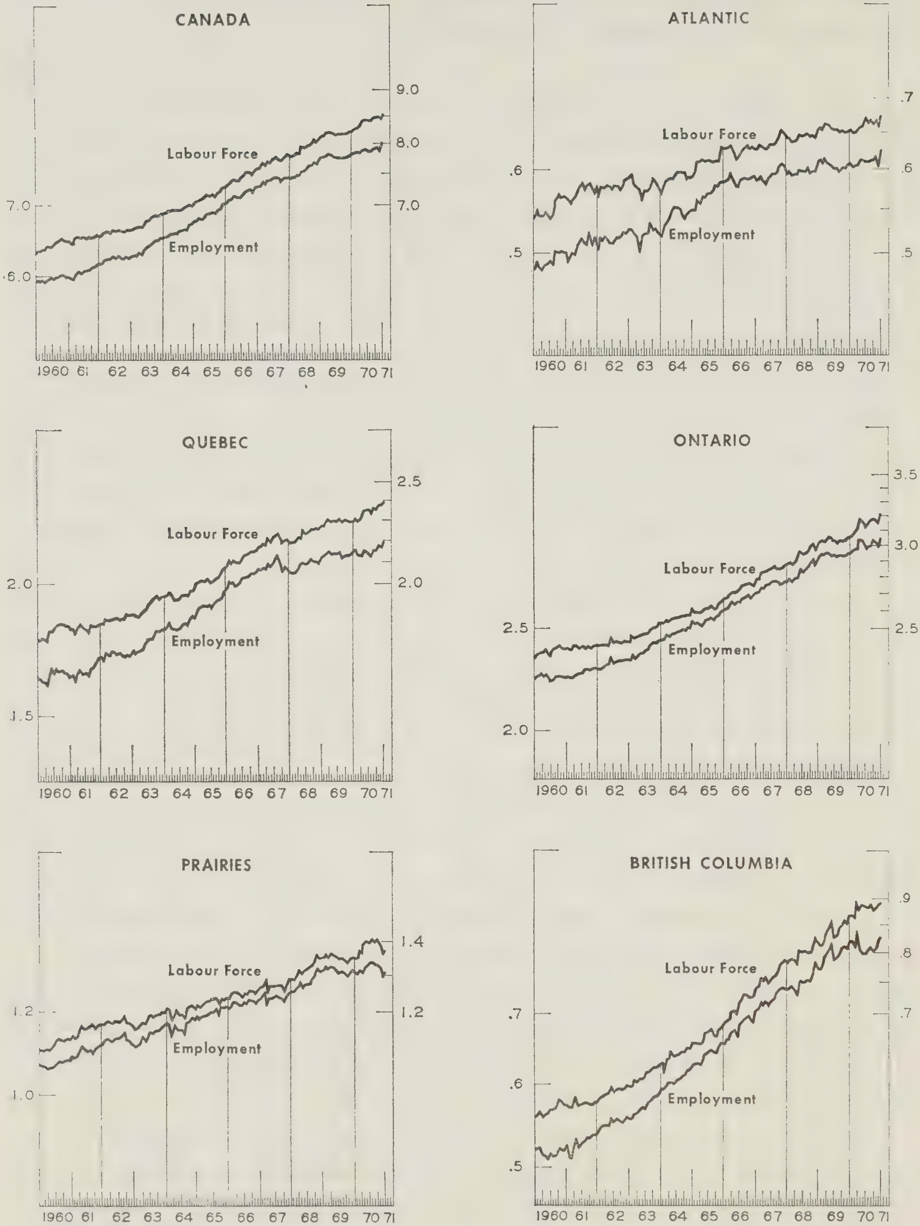
Employment in the *Atlantic Provinces* continued to grow relatively slowly. However, as the labour force increased only slightly, in part because of outward migration and a continued relatively low level of labour force participation by women, the unemployment rate was averaging a bit below 8 per cent in the latter part of 1970 as it did a year earlier. Compared with 1969, the *Newfoundland* economy showed the greatest improvement: iron ore production recovered from a lengthy strike in 1969, output of newsprint rose moderately, markets for fish products strengthened and business capital outlays apparently were up quite strongly. A substantial increase in business capital expenditures was also planned in *Nova Scotia* but labour unrest was more serious in that province, particularly in the construction and fishing industries. However, the steel industry experienced a relatively favourable year and though coal production declined as rationalization of production continued, there were signs of a recovery in demand. In *New Brunswick* the forest industries did not show much strength and business investment intentions were little changed from 1969.

The charts on page 33 show the recent trends of a number of economic aggregates on a regional basis; regional labour market developments are summarized and placed in the perspective of the last ten years in the charts on pages 36 and 37.

REGIONAL LABOUR FORCE AND EMPLOYMENT

Monthly — Millions

Ratio Scale



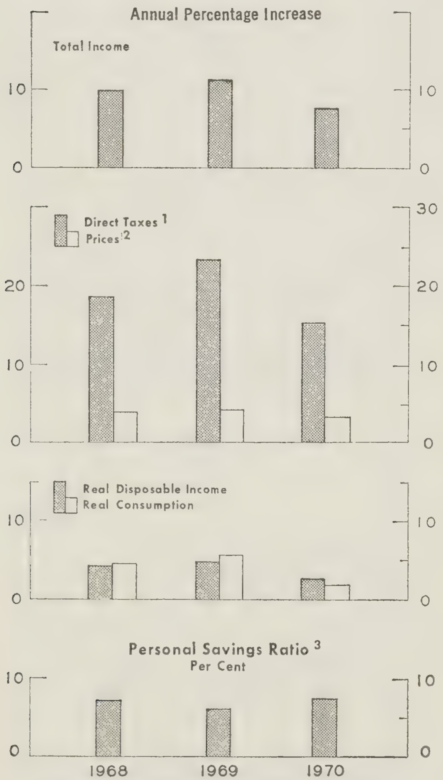
Seasonally adjusted.

REGIONAL UNEMPLOYMENT RATES

Per Cent

PERSONAL SECTOR. Total consumer expenditure in 1970 was only about 5¼ per cent higher than in 1969, little more than half the strong rise in the previous year. The change was most evident in outlays on durable goods which declined by 5½ per cent. Sales of North American produced cars improved only slowly from the level reached early in 1970 and were sharply reduced by the disruption of production of the latter part of the year; sales of models produced overseas, however, rose further during the year and substantially increased their market share. Expenditures on other durable goods and on semi-durables increased only slightly. The slower pace of outlays on services partly reflected the continued switching of some medical expenses to the public sector as a result of increased provincial participation in Medicare. (See page 42)

PERSONAL INCOME AND EXPENDITURE



1. Includes contributions to social insurance and government pension funds.
2. Implicit GNE consumption deflator.
3. Excluding farm inventories.

As shown in the chart, incomes before taxes rose by nearly 8 per cent in 1970, much less than in 1969. There was a slower rise in non-farm income from all sources and a sharp decline in net income received by farmers. The impact of these developments on real personal disposable income was somewhat cushioned by the smaller increase in personal direct taxes and some improvement in price performance. The proportion of disposable income saved rose appreciably in 1970.

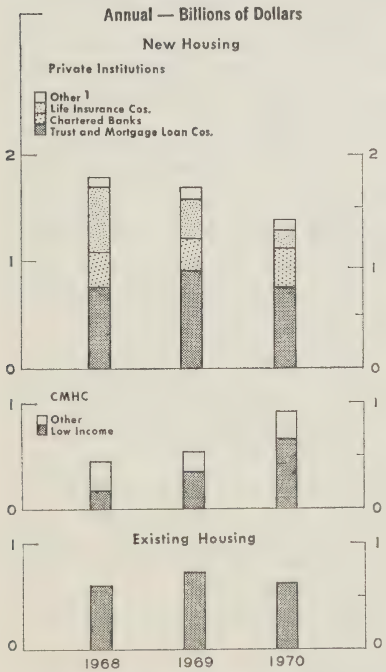
The growth of consumer credit slowed markedly in the second half of 1969 and the early months of 1970. Despite a strengthening later in the year, consumer credit outstanding for the year as a whole rose by about $660 million, not much more than one half of the increases of over $1.2 billion in 1968 and 1969. Due to a strong recovery in the second half of 1970, chartered bank unsecured personal loans increased by slightly more than in the previous year but credit extended by other lenders fell to around one fifth of its high 1969 level.

HOUSING SECTOR. Residential construction expenditures, which had been at a record level in 1969, declined sharply in the first half of 1970. Despite a marked recovery late in the year, for 1970 as a whole they were 8 per cent lower than in the previous year.

These developments reflected with the usual lag the course of housing starts. The downturn in the seasonally adjusted rate of starts which began early in 1969 continued into the first half of 1970. A sharp reversal during the second half of the year, largely related to direct lending programmes by Central Mortgage and Housing Corporation (CMHC) as well as an upturn in lending by private institutions, brought total starts for the year as a whole to 190 thousand units, only 20 thousand less than the record level in 1969. A notable feature of the year was the major shift to construction of low-income units; close to 50 thousand of such units were started, somewhat more than in the previous five years taken together.

HOUSING AND MORTGAGE MARKETS

GROSS RESIDENTIAL MORTGAGE LOAN APPROVALS



1. Quebec savings banks, fraternal and mutual benefit societies.

HOUSING ACTIVITY

Seasonally adjusted at annual rates.
1. Newly completed only, unadjusted.

There are indications that the relatively low level of housing activity in the first half of 1970 was attributable to the high level of land, construction and financing costs, and perhaps to expectations that at least the last might decline. Mortgage interest rates which had risen sharply in 1969 increased slightly further in the first few months of 1970 but then began to edge down; a more significant decline occurred late in the year and early in 1971.

For 1970 as a whole, total approvals on new housing amounted to $2.3 billion, an increase of 3 per cent from 1969. Direct lending by CMHC rose by two thirds to $915 million, largely to finance low-income housing, and much more than accounted for the increase in total approvals. The decline in the year in new housing approvals by private institutions amounted to 17½ per cent. Approvals by trust and mortgage loan companies and life insurance companies both decreased, though in the latter case the impact was partly offset by direct participation in real estate projects. In contrast, the chartered banks increased their new residential approvals substantially from the relatively low level in the previous year.

BUSINESS SECTOR. Business investment in new plant and equipment is now estimated to have been 8 per cent higher in 1970 than in the previous year, much the same rate of increase as in 1969. Non-residential construction outlays apparently rose by about 10 per cent, while spending on equipment increased by about 6 per cent. There was some moderation in the rate of price increase, especially in construction materials. The physical volume of business fixed investment rose by about 4½ per cent. As shown in the chart, business investment in relation to GNP remained appreciably below the peak reached in 1966.

The increase in investment outlays by private business in 1970 was accompanied by a recovery in internal cash flow. Although corporate retained earnings declined, especially in the fourth quarter, this was more than offset for the year as a whole by increases in other sources of internal funds, mainly capital consumption allowances. In the event, the amount of funds raised externally by business in 1970 was nearly one third less than the high level in 1969.

BUSINESS FIXED INVESTMENT
Excluding Housing
Annual — Billions of Dollars

Note: The contour lines enable one to see the ratio of investment to GNP in each year.

Marked shifts occurred during 1970 in the form in which business acquired funds. Much more of the financing was in domestic long-term debt rather than in equities or in short-term forms such as bank loans. In the course of the year there was a substantial increase in funds raised in the Canadian bond market and a reduction in foreign currency issues. The depressed condition of North American stock markets for much of the year led to a sharp reduction in the volume of new equity issues at home and abroad.

MAJOR SOURCES OF EXTERNAL FUNDS OBTAINED BY NON-FINANCIAL BUSINESS

(millions of dollars)

	Annual			Semi-annual 1970	
	1968	1969	1970	I	II
Net new issues of:					
Bonds					
Canadian-pay	395	372	963	281	682
foreign currency	329	355	310	229	81
Stocks					
Canadian-pay	487	605	239	205	34
foreign currency	38	191	18	18	—
Commercial paper and bankers' acceptances	99	303	183	274	– 91
Sub-total	1,348	1,826	1,713	1,007	706
Increases in loans:					
Chartered banks(1)	648	1,307	439	319	120
Sales finance companies	245	180	– 167e	53	–220e
Industrial Development Bank	42	54	68	35	33
Sub-total	935	1,541	340e	407	– 67e
Net direct investment from abroad	365	400	545	185	360
Total	2,648	3,767	2,598e	1,599	999e

e: Estimate.

(1) Total business loans excluding provincially-guaranteed loans to utilities, plus foreign currency loans to residents.

GOVERNMENT SECTOR. Direct government* purchases of goods and services increased by about 14 per cent in 1970, substantially more than in the preceding year. This more rapid growth reflected a sharp increase at the provincial-municipal level as the growth of federal purchases eased substantially.

Excluding defence, the increase for the federal Government was about 6½ per cent in 1970 as compared with 26 per cent in 1969 when there were large retroactive pay increases for public servants. Defence expenditures, which had remained virtually unchanged in the two previous years, increased by 3½ per cent in 1970.

At the provincial-municipal level, outlays on goods and services increased by about 18 per cent compared with 10 per cent in 1969. The acceleration reflected the first full year's participation in Medicare by five provinces and the inception of the plan in Quebec. Wage and salary costs continued to climb at a rapid pace during the year while capital expenditures, which had abated in the previous two years, resumed their upward trend.

In addition to increasing their direct purchases of goods and services, governments continued to expand their transfer payments to other sectors of the economy at about the same rate as in 1969. In total, government expenditures on the national accounts basis increased by 13½ per cent compared with 11½ per cent in 1969.

There was also some increase in 1970 in the federal Government's large lending operations; these give rise to financing requirements and importantly affect the level of spending attributed to other sectors in the national accounts. Federal lending through CMHC was increased appreciably, and a number of other lending programmes, especially those for the financing of exports and international development, also gave rise to higher disbursements. In total, net loans and advances added almost $1 billion to over-all cash requirements and, in addition, close to $1.6 billion in Canadian currency was required by the Government to finance the increase in foreign exchange reserves.

Total revenues of the government sector on a national accounts basis (excluding net receipts under the Canada and Quebec Pension Plans) rose by less than 10 per cent in 1970 compared with about 16 per cent in 1969. The slowdown in the rate of increase was mainly concentrated in federal receipts from personal and corporate income taxes. While there were no major provincial tax increases, revenues at that level were considerably strengthened by substantially higher transfers from the federal Government, and provincial-municipal revenues continued to increase at about the same rate as in 1969.

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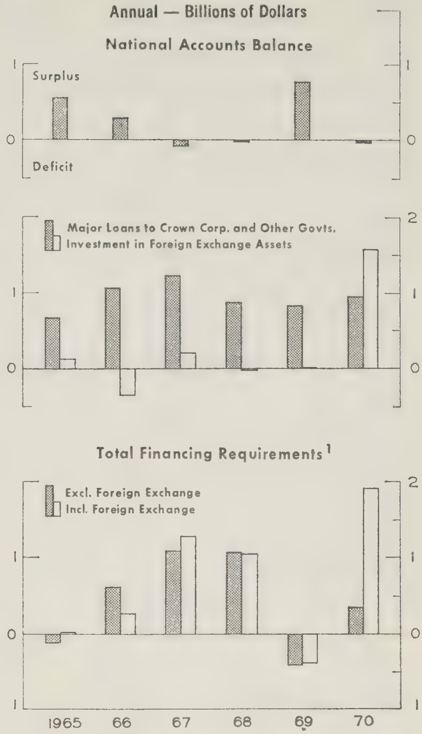
* Including hospitals which are now treated as a sub-sector of governments in the national accounts.

The marked slowing of growth in the Government of Canada's receipts coupled with a larger increase in its total expenditures, some rise in its lending, and its very substantial purchases of foreign exchange resulted in a swing in its net Canadian dollar position from a surplus of $400 million in 1969 to a cash requirement of $1.9 billion in 1970. (For further details on the Government of Canada cash requirements and on the way in which these and provincial-municipal requirements were financed, see Appendix Tables III and IV and for the discussion of debt management operations see page 61.)

GOVERNMENT OF CANADA ACCOUNTS



1. Includes the effect of other asset and liability changes not shown above.

The more rapid increase in the expenditures of provinces and municipalities was offset by an apparent decline in their loans and advances and, with provincial-municipal revenue rising at about the same rate in the two years, the combined borrowing requirements of provincial and municipal governments and their business enterprises in 1970, at $2.3 billion, were slightly less than in 1969. Almost half of these requirements were met by the sale of securities to the Canada and Quebec Pension Plans. Provincial-municipal borrowings abroad were reduced substantially from the preceding year.

SUMMARY OF EXTERNAL FINANCING OBTAINED BY MAJOR SECTORS. The total of external funds obtained by major non-financial sectors in 1970 was nearly $0.5 billion less than in the previous year despite the marked increase in borrowing undertaken by the Government of Canada. The decline was concentrated in the business sector where loans obtained from financial intermediaries, principally the chartered banks, decreased sharply. Consumer borrowing and net investment in mortgages by private financial institutions were also lower. The implications of these demands for funds on credit markets are discussed in the following section of this Report.

FUNDS RAISED BY NON-FINANCIAL SECTORS

(millions of dollars)

				Changes in funds raised	
	1968	1969	1970	1969	1970
Consumers	1,217	1,264	660e	+ 47	− 604e
Mortgagors(1)	1,230	1,595	1,330e	+ 365	− 265e
Non-financial business(2)	2,648	3,767	2,598e	+1,119	−1,169e
Provincial and municipal governments(3)	2,249	2,259	2,100	+ 10	− 159
Sub-total	7,344	8,885	6,688e	+1,541	−2,197e
Government of Canada(4)	1,109	278	1,992	− 831	+1,714
Total	8,453	9,163	8,680e	+ 710	− 483e

e: Estimate.

(1) Excludes net mortgage lending by governments and their agencies, notably CMHC, which is reflected in the financing requirements of the respective governments.

(2) Excludes agriculture.

(3) Excludes loans from the Government of Canada but includes securities purchased by the CPP and QPP.

(4) Excludes net new foreign currency issues and changes in holdings of Government accounts.

Financial Developments in Canada

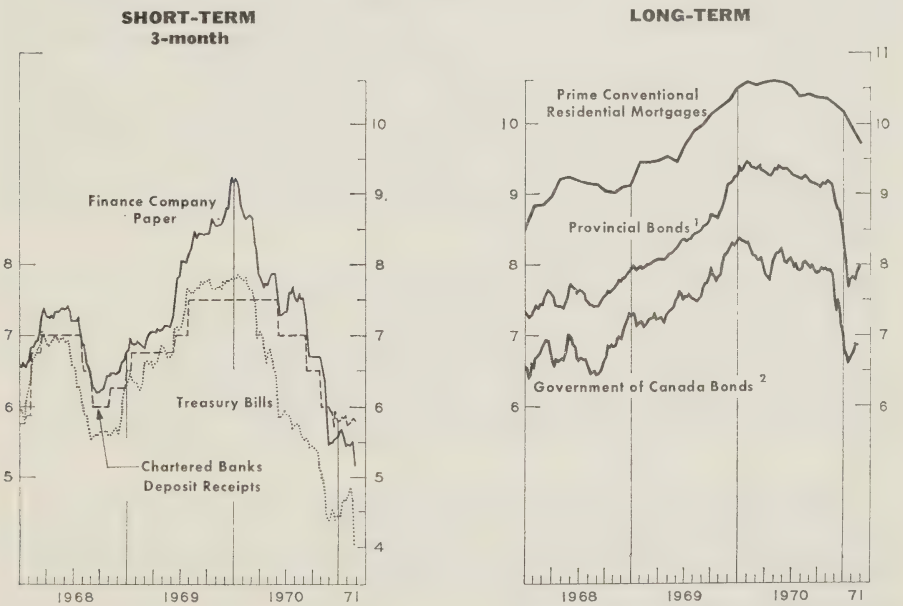
GENERAL REVIEW

Credit conditions in Canada eased substantially in 1970. Interest rates declined from the beginning of the year and after the first quarter credit became progressively more readily available to all classes of borrowers.

Yields on short-term securities fell by more than 3 percentage points during the year; the three-month treasury bill rate declined from 7.81 per cent to 4.44 per cent while the rates offered by sales finance companies on their 90-day paper fell from 9.17 per cent to 5.57 per cent. At the end of February 1971

INTEREST RATES

Per Cent



1. Wednesday average yield on 10 provincials included in the monthly series published by McLeod, Young, Weir and Co. Ltd.
2. Wednesday average yield on bonds with a maturity of 10 years or over.

these rates were 4.04 per cent and 5.15 per cent respectively. The lending and deposit rates of financial institutions were also lowered substantially after mid-year. At the end of February 1971, for example, the prime rate charged by most of the chartered banks was 6½ per cent, compared with 8½ per cent a year earlier; the rate they paid on non-chequable savings accounts was down from 6½ per cent to 4½ per cent.

The decline in longer-term interest rates was also substantial; bond yields fell 1 to 1½ percentage points, with most of the reduction occurring late in 1970. The average yield on long-term Government of Canada bonds moved down irregularly from 8.33 per cent at the beginning of the year to just below 8 per cent by the beginning of September and after mid-November fell sharply; at the end of February 1971 it was 6.85 per cent. Provincial and municipal securities showed comparable declines while yields on corporate securities fell somewhat less. The reduction in mortgage rates tended to lag behind that of most other rates; by February 1971 they were about 90 basis points below their April 1970 peak.

The decline in interest rates was accompanied by a substantial increase in the availability of funds from the banks as their liquidity rose and also—particularly in the second half of the year—through the bond market. The greater availability of credit in the Canadian bond market and the development of interest rate relationships that provided little or no incentive to borrowing abroad resulted in a substantial shift away from reliance on foreign capital markets. In order to give further discouragement to the inflow of foreign exchange the Minister of Finance and the Bank of Canada suggested to borrowers that they carefully explore the domestic market before placing issues abroad. In 1970 net borrowing from non-residents amounted to about $850 million, down sharply from about $2 billion in 1969.

The major influences on credit conditions were the shift in monetary policy in recognition of the domestic economic situation, the declining trend of interest rates abroad and the strength of Canada's over-all external position. There was also a change in the nature of the demands on credit markets particularly as corporations lengthened their debt structure. An important influence later in the year was the change in investor expectations regarding the trend of interest rates.

Monetary policy, which had continued to be restrictive as the year opened, shifted in the first quarter of 1970. The subsequent acceleration in the growth of total bank assets enabled the banks to begin restoring their depleted liquidity, a process which continued for the balance of the year. The ratio of Canadian liquid assets to total major assets rose from 26.5 per cent in February to over 30 per cent at year-end and there was also a considerable increase in net foreign

INTEREST RATE COMPARISONS

1. Average of daily figures.

Note: This chart shows the trend of yields on outstanding issues but does not provide a precise indication of yields on new security issues.

1. Wednesday average yield on the 10 provincials included in the monthly series published by McLeod, Young, Weir and Co. Ltd.
2. Wednesday average yield on the 40 public utility bonds published by Moody's Investors Services.

assets over the same period.* Holdings of Canadian liquid assets in excess of those required to meet cash and secondary reserves expressed as a percentage of total major assets rose from 12.4 per cent to 16.2 per cent over the same period.

During the last three quarters of 1970 the banks' total major assets rose at an annual rate of 13.4 per cent while the "money supply", defined to include currency and all privately-held Canadian dollar chartered bank deposits, rose by 13.5 per cent. For the year as a whole the increase in chartered bank assets

* In previous Annual Reports it was the practice to include net foreign assets with Canadian liquid assets in describing the over-all liquidity of the banking system. On this basis the ratio rose from 25.7 per cent to 30.8 per cent.

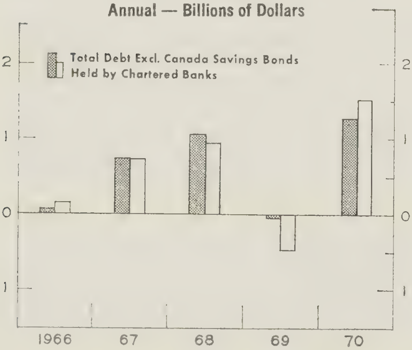
was 9.4 per cent while the privately-held "money supply" increased by 10.9 per cent. "Money supply" more narrowly defined to include only currency and Canadian dollar demand deposits increased by 5.4 per cent. In the United States, the increases in "money supply" measured in the same way were 11.6 per cent and 5.4 per cent respectively in 1970.

The weaker over-all demand for funds by borrowers other than the Government of Canada was an important factor affecting credit conditions in 1970. As noted in the previous section of this Report, total external financing (including borrowing abroad) by provinces, municipalities, non-financial business, consumers and mortgagors declined from $8.9 billion in 1969 to $6.7 billion in 1970. (See table on page 44)

In contrast, there was a substantial increase in the amount of funds used by the Government of Canada. The cash receipts of the Government had exceeded disbursements by $0.4 billion in 1969 in all operations other than those associated with changes in debt, while in 1970 its total cash requirements amounted to $1.9 billion. Of this total swing of $2.3 billion, $1.6 billion was required to finance an accumulation of exchange reserves, and the remaining $0.7 billion was more than accounted for by the shift from a budgetary surplus to a deficit. After allowing for changes in cash balances there was an increase in Government borrowing from $0.3 billion in 1969 to $2.0 billion in 1970. Of the total increase in public debt during 1970, $0.7 billion was raised through the sale of Canada Savings Bonds and the remaining $1.3 billion from new issues of marketable securities. Details of the Government's expenditure and financing are given in Appendix Tables III and IV.

CHANGE IN GOVERNMENT OF CANADA DEBT OUTSTANDING

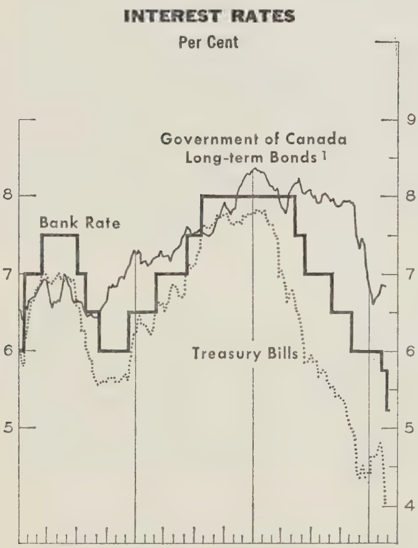
Annual — Billions of Dollars



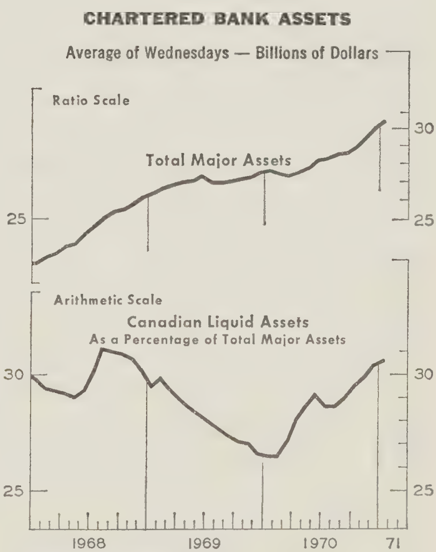
Under the monetary policy followed and in the absence of strong private demands for bank credit, this marked increase in Government borrowing did not prevent a general easing of credit conditions. The increase in total bank assets was large enough to accommodate substantial additions to holdings of Government securities — indeed, the chartered banks acquired an amount of Government securities greater than the net increase in market issues outstanding.

In the first quarter of 1970 a gradual easing in credit conditions, encouraged by monetary policy, was considered appropriate in view both of the developing slack in the economy and the inflow of foreign exchange that was occurring. By the end of March the substantial reduction in short-term interest rates abroad enabled the Bank of Canada to withdraw its earlier request to the banks that they regard their July 15, 1969 level of swapped deposits as a temporary ceiling.*

Monetary management in the second quarter was complicated by an acceleration in the rate of inflow of foreign exchange which came at a time when bank liquidity was already rising quite rapidly and interest rates, particularly short-term, were continuing to fall. The use of Government balances to purchase foreign exchange had the effect of expanding the total of privately-held bank deposits at a very rapid rate. In mid-May when Government cash balances were replenished by the sale of a special issue of $250 million of treasury bills, the Bank of Canada offset the effect of this on the available liquidity of the chartered banks by raising the minimum secondary reserve ratio from 8 per cent to 9 per cent of chartered bank deposit liabilities. At the same time the Bank Rate was reduced from 8 per cent to 7½ per cent, bringing it more into line



1. Wednesday average yield on bonds with a maturity of 10 years or over.



Seasonally adjusted.

* This measure had been reinforced in January 1970 when the Bank of Canada asked investment dealers and trust companies not to arrange similar transactions in other ways. Swapped deposits are funds converted into a foreign currency, usually U.S. dollars, which have been placed as term deposits with a bank and which the bank has undertaken through a forward contract to convert back into Canadian dollars at maturity.

with short-term market rates. At the end of May when the Government decided to allow the Canadian dollar to float temporarily, the Bank Rate was reduced by a further ½ per cent to 7 per cent.

By mid-year the chartered banks' Canadian liquid assets had risen by nearly $800 million from their February level and as a percentage of total major assets they had increased from 26.5 per cent to 29 per cent. The rate of monetary expansion, which was influenced by the large inflows of foreign exchange, had been unusually rapid and in July the Bank of Canada shifted its cash reserve management policy temporarily so as to moderate the growth of the banks' liquid and total assets. In August cash management was eased again and the Bank Rate was lowered to 6½ per cent at the end of the month. The growth in the banks' Canadian liquid assets was resumed and the liquid asset ratio rose. The Bank Rate was reduced on November 12 by a further ½ of one per cent to 6 per cent.

During the closing months of 1970 a substantial further easing of credit conditions occurred in the United States and Canada; interest rates fell very sharply. In a climate of buoyant expectations about the trend of bond prices and with a rapid expansion in the volume of Government market securities outstanding, the Bank of Canada exercised some considerable restraint from mid-November through January 1971 on the amount of cash reserves available to the chartered banks in excess of the minimum requirement. Nonetheless, monetary expansion was unusually rapid during this period and the banks' Canadian liquid asset ratio rose to well over 30 per cent by January 1971.

A change of the environment in financial markets became evident about the beginning of February and the Bank of Canada pursued an easier policy with respect to chartered bank cash reserves; the expansion of the banks' liquid assets resumed. The Bank Rate was reduced in two stages by a further ¾ per cent to 5¼ per cent in February.

In line with the general decline in yields on short-term market instruments during 1970, the chartered banks on several occasions reduced the interest rates offered for large Canadian dollar term deposits. These deposits continued during most of the year to be subject to the request of the Bank of Canada to the larger banks that they limit the rates offered on such deposits. Late in the year, however, this request no longer appeared to be required in the light of the easier monetary conditions and it was withdrawn.

Despite generally easier monetary conditions somewhat greater use was made of central bank credit in 1970. Advances by the Bank of Canada to chartered banks were outstanding on 35 business days, the same number of days as in 1969, and purchase and resale agreements with money market dealers were outstanding on 125 business days compared with 93 days in the previous year. The average daily amount of advances outstanding was $1.8 million in

1970, up from $1.2 million in 1969. The average daily amount of securities held by the Bank of Canada under purchase and resale agreements was $16.7 million in 1970 and $9.4 million in 1969. On November 10 the Bank announced a technical change in the arrangements under which it was prepared to enter into purchase and resale agreements with money market dealers. A minimum PRA rate was established equal to Bank Rate less ¾ of one percentage point. Subject to this minimum rate and a maximum rate set by Bank Rate, the PRA rate continues to be set at ¼ of one per cent above the average 91-day treasury bill rate at the latest tender.

The monthly changes in the Bank of Canada's holdings of Government of Canada securities in 1970 are summarized in Appendix Table II. The net increase in the Bank's portfolio during the year amounted to $183 million and was more than accounted for by transactions with the securities market. The main changes in the Bank's balance sheet month by month in 1970 are shown in Appendix Table I.

FINANCIAL INSTITUTIONS AND THE GENERAL PUBLIC'S HOLDINGS OF LIQUID ASSETS

A summary table of the major assets of the main financial intermediaries who issue short-term claims which are held by the general public is shown below. In 1970 the assets of this group rose by 8.7 per cent, nearly one percentage point more than in the previous year, with the banks accounting on balance for all of

MAJOR ASSETS OF SELECTED FINANCIAL INSTITUTIONS

	Millions of dollars Dec. 1970	Increase in millions of dollars		Percentage increase			
		1969	1970	Average 1964-67	1968	1969	1970
Chartered banks(1)(2)	30,184	1,306	2,603	10.9	14.2	5.0	9.4
Quebec savings bank(1)	543	31	38	7.2	15.6	6.5	7.5
Trust and mortgage loan companies	9,516e	981	1,085e	13.0	11.8	13.1	12.9e
Sales finance and consumer loan companies	5,140e	669	−143e	7.5	10.7	14.5	−2.7e
Credit unions and caisses populaires	4,311e	328	374e	14.8	11.0	9.1	9.5e
Total	49,694e	3,315	3,957e	11.1	13.1	7.8	8.7e
Total excluding chartered banks	19,510e	2,009	1,354e	11.5	11.4	12.4	7.5e

e: Estimate.

(1) For comparability the assets of The Quebec Savings Bank which became a chartered bank in November 1969 are included with chartered bank assets prior to that time.

(2) Major Canadian dollar assets plus net foreign currency assets; average of Wednesdays.

the increase. Excluding the sales finance and consumer loan companies, whose growth was adversely affected by the sluggishness of car sales, the other financial institutions grew at about the same rate as in 1969.

The general public's holdings of deposits and other liquid claims rose considerably more in 1970 than in the previous year as shown in the table below. A review of developments in a number of groups of financial institutions follows.

GENERAL PUBLIC HOLDINGS OF CERTAIN FINANCIAL ASSETS

	Millions of dollars Dec. 1970	Percentage increase			
		Average 1964-67	1968	1969	1970
Currency	3,473	7.8	9.2	9.7	5.9
Chartered bank demand deposits(1)	6,229	7.3	5.3	0.9	5.1
Sub-total	9,702	7.5	6.6	3.9	5.4
Other chartered bank Canadian dollar deposits(1)	21,038	13.8	16.8	3.3	13.6
Sub-total	30,740	11.4	13.2	3.5	10.9
Chartered bank foreign currency deposits of residents					
— swapped	1,689	8.1	−15.8	103.3	8.9
— other	1,500	19.9	22.2	34.2	−12.4
Sub-total: currency plus all chartered bank deposits shown above	33,929	11.6	12.6	7.5	9.5
Credit unions and caisses populaires deposits	2,745e	16.6	13.7	16.4	16.1e
Quebec savings bank deposits(1)	532	7.4	15.1	7.9	7.7
Trust and loan company deposits	8,644e	13.2	12.0	13.5	14.2e
Sub-total: obligations of the financial institutions shown above	45,850e	12.1	12.6	9.0	10.7e
Short-term paper holdings of residents	2,280e	16.2	36.1	12.8	− 7.7e
Canada Savings Bonds	7,397	4.0	0.6	5.1	10.7
General public holdings	55,527e	10.8	11.7	8.7	9.8e

e: Estimate.

(1) For comparability the deposits of The Quebec Savings Bank which became a chartered bank in November 1969 are included with chartered bank deposits prior to that time.

CHARTERED BANKS. In the final nine months of 1970 total major assets of the chartered banks rose at an annual rate of 13.4 per cent compared with no change in the previous nine-month period. The banks were able to rebuild their liquid assets which had been substantially reduced over the previous eighteen months, and Canadian liquid assets as a percentage of total major assets increased from about 27 per cent in March 1970 to over 30 per cent at year-end. The restoration of Canadian liquid assets was accompanied by an improvement in the net foreign position of the banks. The table below compares changes in the final nine months of 1970 with the preceding eighteen months.

CHANGES IN CANADIAN LIQUID AND NET FOREIGN ASSETS

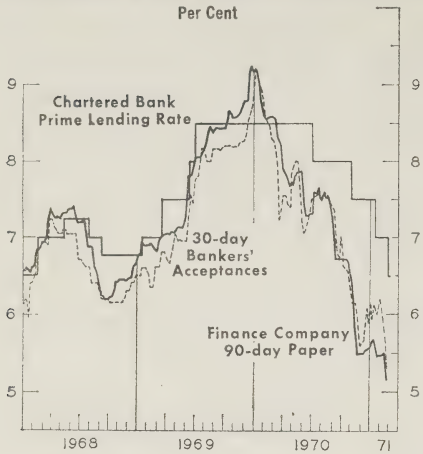
(average of Wednesdays — millions of dollars)

	September 1968 to March 1970	March 1970 to December 1970
Day-to-day loans	+ 15	− 40
Government of Canada treasury bills	− 291	+ 618
Government of Canada bonds	− 306	+ 893
Call loans	− 225	+ 354
Canadian earning liquid assets	− 808	+1,827
Bank of Canada notes and deposits	+ 159	+ 58
Canadian liquid assets	− 649	+1,885
Canadian liquid asset ratio at end of period (per cent) (31.4) Sept. 1968	(26.9)	(30.5)
Net foreign assets	− 646	+ 351
Total	−1,296	+2,235

The increase in bank liquidity was accompanied by an easing in lending policies, and during the second half of the year general loans increased at an annual rate of 12 per cent.

Business loans which are a major component of general loans picked up in the second half of the year though they were relatively flat over the year as a whole. Their performance reflected the slower expansion of the Canadian economy and the use of alternative sources of credit, particularly bankers' acceptances and financing on the domestic bond market. Most banks reduced their prime lending rate in four stages from 8½ per cent in June to 6½ per cent

SHORT-TERM PAPER RATES AND CHARTERED BANK PRIME LENDING RATE



at the end of February 1971. As shown in the table on the Bank of Canada's quarterly sample survey of interest rates charged on new demand loans, there was a substantial decline in the average rate in the second half of 1970. A further indication of the increased willingness of the banks to make business loans is provided by the rise in business loan authorizations (for lines of credit of $100,000 and over) in the last nine months of the year. Outstanding authorizations rose by $1,381 million in the final three quarters of 1970 compared with $834 million in the same period of the previous year. The combination of rising authorizations and little growth in outstanding business loans sharply reduced the utilization of lines of credit. From its peak of 54 per cent in March 1970 the ratio of loans outstanding to authorized lines of credit declined to 49 per cent by year-end, its lowest level since 1965.

SAMPLE SURVEY OF INTEREST RATES CHARGED ON NEW DEMAND LOANS*

			Distribution of loans by dollar volume — cumulative percentages			
Date of survey	**Prime rate**	**Average rate on new demand loans(1)**	**At prime**	**At prime plus ¼% or less**	**At prime plus ½% or less**	**At prime plus ¾% or less**
1969						
Feb.	7.00%	7.35%	45	62	79	88
May	7.50	7.78	54	65	82	91
Aug.	8.50	8.79	53	61	82	92
Nov.	8.50	8.78	60	67	83	90
1970						
Feb.	8.50	8.85	51	58	78	84
May	8.50	8.83	52	61	80	87
Aug.	8.00	8.44	45	51	73	87
Nov.	7.50	7.97	49	58	73	79

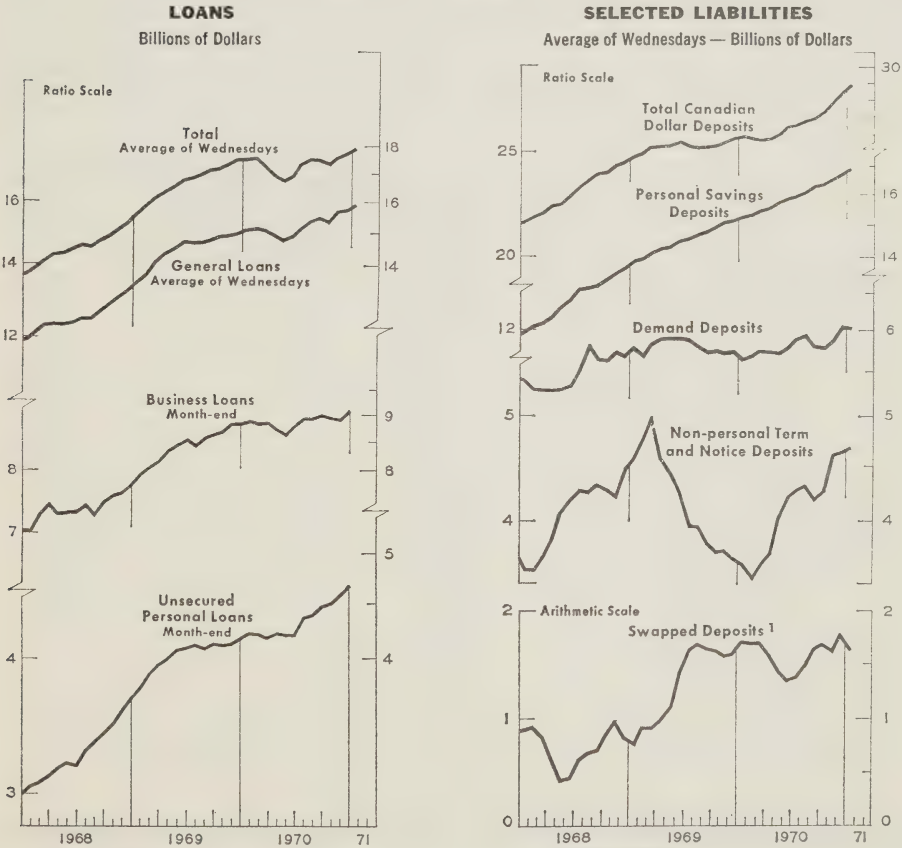
* The term "new" loans is defined as any transaction whereby a customer's account is credited with funds during the three selected survey days, whether under existing or renewed authorizations. Specifically excluded are unsecured personal loans, mortgage loans, day loans, call loans, loans to grain dealers and loans carried on an overdraft basis.

(1) Weighted by dollar volume.

Loans to consumers, the other major component of general loans, recovered rapidly after mid-year growing at a seasonally adjusted annual rate of 22 per cent compared with about 2 per cent in the first half of the year. The share of total consumer credit granted by the banks rose and there appears also to have been some refinancing of consumer debts contracted elsewhere when the banks were rationing such loans during 1969.

Total Canadian dollar deposit liabilities of the chartered banks rose at an annual rate of nearly 15 per cent in the last nine months of 1970, compared with virtually no growth in the preceding nine months. Demand deposits, which had previously been declining, grew at an annual rate of 6.9 per cent. Personal savings deposits increased at a faster rate in the recent nine-month period and this was accompanied by a more modest shift from chequable into higher-yielding

CHARTERED BANKS



Seasonally adjusted.

Seasonally adjusted.
1. Unadjusted.

non-chequable deposits than had been observed in earlier periods. The movement out of bank domestic term deposits into swapped deposits and other short-term instruments which had been such a prominent feature in 1969 was not evident in 1970. Indeed, non-personal term and notice deposits at the banks rose by nearly $1 billion in the final nine months of 1970. This left them $340 million below their peak in the first quarter of 1969. In contrast, swapped deposits during the last three quarters of 1970 rose by only $69 million compared with an increase of almost $1 billion in the preceding eighteen months.

The interest rates offered by the banks on various types of deposits were reduced after mid-year. Between July 1970 and February 1971 non-chequable personal savings deposit rates were lowered from 6½ per cent to 4½ per cent. Rates offered on large Canadian dollar deposits with a term of about 90 days fell from 7.5 per cent in May to an average of about 5.8 per cent in February 1971. The declines in short-term rates abroad were reflected in the much lower rates offered by the banks for swapped deposits during the year.

CHARTERED BANK MAJOR ASSETS AND LIABILITIES

(average of Wednesdays — seasonally adjusted)

	Millions of dollars Dec. 1970	Percentage changes at annual rates		
		9 months ending June 1969	9 months ending Mar. 1970	9 months ending Dec. 1970
Total major assets(1)	29,992	10.0	—	13.4
Canadian liquid assets	9,126	− 3.1	− 5.3	31.5
Less liquid Canadian assets	20,832	18.0	4.8	4.6
of which: general loans	15,752	20.9	3.5	6.1
(business loans)(2)	(9,082)	(18.6)	(5.0)	(3.5)
(unsecured personal loans)(2)	(4,672)	(26.5)	(3.3)	(15.1)
loans to grain dealers	761	10.6	19.7	−37.3
residential mortgage loans(3)	1,450	27.7	14.3	14.0
Total Canadian dollar deposits	28,426	10.0	0.1	14.7
Demand deposits	6,030	6.2	− 3.7	6.9
Personal savings deposits	16,736	12.6	9.1	11.4
of which: chequable(3)	5,204	−10.7	−17.3	− 5.8
non-chequable(3)	6,784	31.9	27.9	14.9
fixed-term(3)	4,481	37.6	27.2	24.7
Non-personal term and notice deposits	4,644	− 2.1	−18.9	36.2
Government of Canada deposits(3)	1,330	181.3	40.2	30.3
Swapped deposits(2)(3)	1,689	131.9	12.1	6.2
Other foreign currency deposits of residents(2)(3)	1,500	28.3	13.1	−13.6

(1) Includes net foreign assets amounting to $384 million (Sept. 1968); $25 million (June 1969); a negative position of $262 million (Mar. 1970) and $89 million (Dec. 1970).

(2) Month-end figures.

(3) Not seasonally adjusted.

TRUST AND MORTGAGE LOAN COMPANIES. The major assets of the trust and mortgage loan companies increased by almost 13 per cent in 1970, about the same as in 1969. There was a modest deceleration in the rate of growth of mortgage loans outstanding on the books of these companies—from 16 per cent in 1969 to 14 per cent last year—reflecting the fairly sharp decline in the volume of mortgage loan commitments from mid-1969 to the end of the first quarter of 1970. The companies accumulated a substantial volume of short-term assets during the year. Most of the funds available to them for investment continued to come from the issue of fixed-term instruments. Interest rates paid on such instruments were lowered during the year, with the typical rate on five-year certificates declining from their March 1970 peak by about 70 basis points by February 1971. There was a similar decline in mortgage lending rates and the companies substantially increased their mortgage loan approvals after the end of the first quarter. In 1970 Canada and the Province of Ontario amended the legislation governing the activities of trust and loan companies under their jurisdiction; the main changes were to broaden the investment powers and increase the borrowing powers of these companies.

TRUST AND MORTGAGE LOAN COMPANIES MAJOR ASSETS AND LIABILITIES

	Millions of dollars December 1970e	Percentage increase			
		Average 1964-67	1968	1969	1970e
Total major assets	9,516	13.0	11.8	13.1	12.9
Cash and short-term investments(1)	1,060	13.8	30.9	9.3	36.2
Bonds	1,480	7.9	7.3	4.7	− 1.9
Government of Canada	644	5.5	10.5	12.1	− 8.8
provincial and municipal	476	8.2	1.1	− 4.1	7.9
corporate	360	12.4	10.7	3.1	− 0.8
Mortgage loans and sales agreements	6,596	15.1	10.6	16.3	14.3
Other assets(2)	380	6.7	16.6	10.4	2.2
Total major liabilities	8,644	13.2	12.0	13.5	14.2
Demand and savings deposits	1,951	4.5	7.3	3.9	9.6
Guaranteed investment certificates, debentures and other term deposits	6,693	17.1	13.7	16.7	15.6

e: Estimate.

(1) Short-term investments include: Government of Canada treasury bills, term deposits in chartered banks and trust and loan companies, short-term notes of sales finance companies, commercial paper and assets denominated in foreign currency.

(2) Includes collateral loans, preferred and common stocks.

SALES FINANCE AND CONSUMER LOAN COMPANIES. Following two years of rapid growth, the major assets of the sales finance and consumer loan companies declined by 2.7 per cent in 1970. The companies' consumer and business lending was adversely affected by the decline in automobile production and sales during the year, and the amount of receivables outstanding declined. This decline was offset to some extent by a further substantial increase in holdings of cash and securities. During the year the companies sharply reduced their short-term debt, and loans from parent and affiliated companies also declined after increasing substantially in the previous year; long-term debt outstanding increased by 7.5 per cent.

SALES FINANCE AND CONSUMER LOAN COMPANIES MAJOR ASSETS AND LIABILITIES

	Millions of dollars Dec. 1970e	Percentage increase			
		Average 1964-67	1968	1969	1970e
Total major assets(1)	5,140	7.5	10.7	14.5	− 2.7
of which:					
Cash and investments	328	13.3	−11.9	33.3	28.1
Gross receivables	4,900	7.3	11.8	13.7	− 4.1
consumer receivables(2)	3,136	7.5	9.6	16.5	− 1.4
business receivables(2)	1,764	7.0	15.2	9.7	− 8.6
Total major liabilities	4,090	6.7	9.7	14.7	− 5.1
Bank loans	247	5.0	−13.1	29.2	−38.7
Short-term paper	1,415	− 2.5	33.5	17.5	− 8.1
Loans from parent and affiliated companies	804	18.2	2.3	19.7	− 6.1
Long-term debt, with original term of more than one year	1,624	10.5	2.5	6.4	7.5

e: Estimate.

(1) Includes receivables net of allowance for bad or doubtful accounts.

(2) The percentage changes shown for 1969 and 1970 are not strictly comparable with those shown for the earlier period because of changes in the coverage of the series.

LIFE INSURANCE COMPANIES. The pattern of investment by life insurance companies in 1970 was broadly similar to that in 1969. The growth in mortgage investment by the industry decelerated further, mainly reflecting an earlier cutback in residential mortgage loan approvals. However, the volume of mortgage loans approved for non-residential construction in 1970 remained at a relatively high level and there was a further increase in real estate investment. Total bond holdings increased by 4.2 per cent, mainly reflecting increased investment in corporate bonds and short-term paper; investment in preferred and common stocks increased by almost 14 per cent, down from 27 per cent in 1969.

The growth in policy loans was again relatively large but the demand for such loans declined steadily after mid-year as credit became more readily available from other sources. For the year as a whole, total assets grew at a slightly higher rate than in 1969, as shown in the following table.

SELECTED CANADIAN ASSETS OF SIXTEEN LIFE INSURANCE COMPANIES(1)

	Millions of dollars Dec. 1970e	Percentage increase			
		Average 1964-67	1968	1969	1970e
Total Canadian assets	12,770	6.3	5.9	4.3	4.5
of which:					
Government of Canada bonds	315	−15.8	1.4	5.1	2.6
Provincial and municipal bonds	1,345	− 0.8	0.6	− 3.8	− 0.4
Corporate bonds(2)	2,520	8.1	2.6	− 2.0	7.0
Mortgage loans	6,320	8.2	6.3	4.0	1.8
Real estate	600	9.4	6.8	13.2	12.6
Policy loans	654	6.2	14.9	19.3	14.9
Preferred and common stocks	820	21.0	24.6	27.0	13.9

e: Estimate.

(1) Relates to the life branch assets of 16 life insurance companies whose net premium income in Canada in 1969 was 80.1 per cent of the total of all companies registered under the federal insurance acts.

(2) Includes short-term paper.

SECURITIES MARKET FINANCING

There was a substantial increase in the amount of new money raised in domestic capital markets by means of bond issues during 1970. The Government of Canada obtained about $2.0 billion (including treasury bills and Canada Savings Bonds) from domestic sources in 1970 compared with $0.3 billion in 1969. Details of the Government's debt management operations are given in the following section.

While the provinces' and municipalities' net new bond issues amounted to $2.1 billion in 1970, little changed from the previous year, there was a quite pronounced shift from foreign to domestic bond market sources. In 1969 these borrowers raised over $1.0 billion abroad but in 1970 the amount was about $400 million, virtually all of which occurred before August.

The total of net new issues of corporate bonds rose by nearly $600 million in 1970 to $1.5 billion with over 40 per cent of the funds being raised in the final three months of the year. Use of the equity and short-term paper markets both in Canada and abroad was substantially reduced in 1970 compared with previous years.

NET NEW ISSUES OF SECURITIES

(millions of Canadian dollars)

	1968	1969	1970
Funds Raised Through Net New Issues of:			
Government of Canada bonds and treasury bills(1)	1,375	292	1,871
Provincial and municipal securities	2,252	2,205	2,135
Corporate bonds	932	976	1,552
Corporate short-term paper	406	537	69
Corporate stocks	554	989	301
Total funds raised and supplied	5,519	4,999	5,928
Funds Supplied by Increase in Holdings of:			
Bank of Canada			
Government of Canada	135	170	183
Chartered banks			
Government of Canada market issues	943	− 480	1,510
Provincial and municipal securities	48	5	107
Corporate securities	121	2	166
Total chartered banks	1,112	− 473	1,783
Non-bank financial institutions			
Government of Canada market issues	79	89	− 71e
Provincial and municipal securities	− 20	− 29	109e
Corporate bonds and short-term paper	211	84	404e
Corporate stocks	249	408	252e
Total non-bank financial institutions	519	552	694e
Canada and Quebec Pension Plans			
Provincial and municipal securities	864	1,005	1,062e
Other residents			
Canada Savings Bonds	40	324	714
Government of Canada market issues	− 83	179	− 242
Provincial and municipal securities	560	175	455
Corporate bonds and short-term paper	798	775	312
Corporate stocks	129	316	131
Total other residents	1,444	1,769	1,370
Non-residents			
Government of Canada market issues	261	10	− 223
Provincial and municipal securities	800	1,049	402
Corporate bonds and short-term paper	208	652	739
Corporate stocks	176	265	− 82
Total non-residents	1,445	1,976	836

e: Estimate.

(1) Includes net new foreign currency issues which during 1968, 1969 and 1970 were +266, +14, −121 respectively. Excludes changes in holdings of Government accounts.

The demands of the Government of Canada on capital markets for new funds rose substantially in 1970, reflecting the buildup of foreign exchange reserves and the shift in the Government's fiscal position from a budgetary surplus to a deficit. Debt management operations in 1970 involved a net increase of $730 million in treasury bill issues and $573 million in Canadian-pay marketable bond issues. Some details are provided in the table on page 62. In addition, net proceeds from Canada Savings Bonds amounted to $714 million in the year.

The amount of three-month and six-month treasury bills issued at regular weekly auctions was increased from $160 million early in the year to $210 million by the end of December. Special auctions of longer-term bills were held on three occasions. The special issue dated May 15 which consisted of $250 million of 273-day and 364-day bills was specifically designed to provide for part of the financing of the accumulation of foreign exchange.

Canadian dollar marketable bonds were issued on six dates during 1970 for a total amount of $2,725 million against retirements of $2,152 million. The bonds offered were short and medium term but three maturities provided investors with an option to extend the term by an additional ten to twelve years. The emphasis on the short-term and medium-term instruments was designed to limit the impact of the Government's demands on the long-term market, partly in order to encourage other borrowers to make greater use of the domestic bond market.

The May 1 financing operation included a $200 million advance refunding of conversion loan 4¼ per cent bonds due September 1, 1972 by an exchange with holders on a par for par basis for 7 per cent bonds due September 1, 1977, thereby reducing the amount of the 1972 maturity outstanding to $1,067 million.

The 1970-71 Series of Canada Savings Bonds provided an average annual yield of 7¾ per cent for 11 years. The first coupon was 6.75 per cent and the highest coupons 8 per cent. The option of compounding interest was again offered to investors. The yield to maturity offered was less than on the 1969-70 Series and roll-over from previous series was small. This issue became progressively more attractive as the general level of interest rates declined and consequently cash sales established new records. Net sales in the fourth quarter of 1970 amounted to $1,026 million. Late in February the Minister of Finance announced that the sale of this series would be discontinued on March 5, 1971.

Repayment was made of the Government's 1968 borrowing from Italy. This included a note maturing in May equivalent to $35 million; the remaining notes equivalent to $73 million and scheduled to mature in May 1971 and May 1972 were retired in advance in June.

The changes in the distribution of the total funded debt among the four major categories of holders are shown in the table on page 63.

SUMMARY OF DIRECT AND GUARANTEED NEW ISSUES AND RETIREMENTS
GOVERNMENT OF CANADA MARKETABLE SECURITIES*

Date	Issues offered	Amount delivered (millions of dollars par value)	Term to maturity	Yield to maturity	Amount retired (millions of dollars par value)
1970		**(payable in Canadian dollars)**			
Feb. 15	8% June 1, 1971	75	1 yr. 3½ mos.	8.11	
	8% Oct. 1, 1974(1)	200	4 yrs. 7½ mos.	8.13	
		275			285
May 1	Treasury bills	150	210 days	6.80	175
May 1	7% Feb. 1, 1973	150	2 yrs. 9 mos.	7.10	
	7¼% Apr. 1, 1975	225	4 yrs. 11 mos.	7.40	
	7% Sept. 1, 1977(2)	200	7 yrs. 4 mos.	(2)	
		575			575
May 15	Treasury bills	125	273 days	6.61	
		125	364 days	6.60	
		250			
May 15					14(3)
July 1	6½% Apr. 1, 1972	115	1 yr. 9 mos.	6.58	
	6½% July 1, 1973	150	3 yrs.	6.72	
	7¼% July 1, 1975	260	5 yrs.	7.49	
		525			445
Aug. 15	7¼% Dec. 15, 1975(4)	200	5 yrs. 4 mos.	7.25	
Oct. 1	6½% Apr. 1, 1972	100	1 yr. 6 mos.	6.61	
	6¾% July 1, 1973	200	2 yrs. 9 mos.	6.75	
	7¼% Dec. 15, 1975(4)	250	5 yrs. 2½ mos.	7.25	
		550			450
Nov. 27	Treasury bills	225	364 days	4.77	225
Dec. 15	5¼% Dec. 15, 1972	100	2 yrs.	5.36	
	6% June 15, 1974	200	3 yrs. 6 mos.	6.08	
	7% Sept. 1, 1977	300	6 yrs. 8½ mos.	6.90	
		600			375
Dec. 29					8(5)
	Total bonds	2,725			2,152
	Total treasury bills	625			400
		(payable in foreign currencies)			
Apr. 15					1(6)
May 15					35(7)
June 24					73(8)
Oct. 15					1(6)

* Excludes three-month and six-month treasury bills.
(1) Exchangeable at the option of the holder on or before April 1, 1974, for an equal par value of 8% bonds due October 1, 1986.
(2) Offered in exchange for an equal par value of Government of Canada 4¼% bonds due September 1, 1972.
(3) Cancellation of securities held by Purchase Fund of 5½% August 1980 bonds.
(4) Exchangeable at the option of the holder from December 15, 1974 to June 14, 1975 into an equal par value of 8% bonds due December 15, 1985.
(5) Cancellation by purchase funds of the following Canadian National Railway bonds: $2.5 million of 5½% December 1971; $1.1 million of 5% May 1977; $1.6 million of 5¾% January 1985; $2.7 million of 5% October 1987.
(6) Partial redemption at par of U.S.-pay 5% October 15, 1987 for the Sinking Fund.
(7) Maturity of 5¾% Italian lira note issued May 15, 1968.
(8) Cancellation of 5⅞% May 15, 1971 and 6% May 15, 1972 Italian lira notes issued May 15, 1968.

GOVERNMENT OF CANADA DIRECT AND GUARANTEED SECURITIES ANNUAL CHANGE IN DISTRIBUTION OF HOLDINGS BY TYPE OF ISSUE

(change as of December 31 — millions of dollars)

	1966	1967	1968	1969(1)	1970
Bank of Canada					
Treasury bills	−200	132	−85	26	144
Bonds	201	202	220	144	39
Total	1	334	135	170	183
Chartered banks					
Treasury bills	198	175	403	−28	598
Bonds	−31	565	540	−452	912
Total	167	740	943	−480	1,510
General public					
Treasury bills	13	−13	42	69	−22
Bonds	−265	−357	215	215	−514
Canada Savings Bonds	223	230	40	324	714
Total	−29	−140	297	608	178
Government accounts					
Treasury bills	10	−10	9	3	10
Bonds	281	−24	161	45	−37
Total	291	−34	170	48	−27
Total change	430	900	1,545	346	1,844

(1) Includes an increase amounting to $6 million in the value of foreign-pay securities as a result of the revaluation of the Deutsche mark.

Canadian Balance of International Payments

SUMMARY

There were major changes in 1970 in Canada's international payments position on both current and capital accounts. The current account balance strengthened dramatically from a deficit of $750 million in 1969 to a surplus of $1,300 million. This development reflects in part an underlying trend towards larger trade surpluses which appears to have emerged during the 1960s, but it was also greatly influenced by strikes and other special factors which had an unfavourable impact in 1969 and a favourable impact in 1970 on trade in a number of important commodities. The trade surplus was also increased by the coincidence of a high level of economic activity in overseas countries and a period of slower growth in Canada, and by the fact that demand for imports in the United States was unusually well maintained in the light of economic developments in that country. During the first five months of the year capital inflows continued to be substantial and official international reserves rose rapidly. At the end of May the limits then in effect for the exchange value of the Canadian dollar were suspended, and the Canadian dollar rose immediately. In the rest of the year there was an appreciable reduction of capital inflows, but the current account remained in substantial surplus and the exchange value of the Canadian dollar rose further.

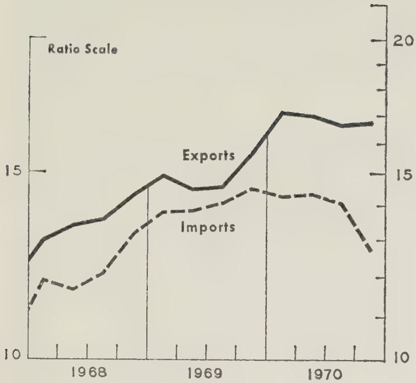
CURRENT ACCOUNT

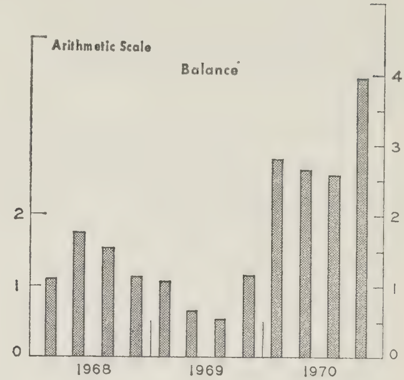
Canada's merchandise exports rose by 13 per cent in 1970 following an increase of 10 per cent in 1969. In volume terms, the increase in Canadian exports was 10 per cent, somewhat higher than the growth rate for world trade. Labour disputes have distorted the pattern of trade over the past few years. At various times during the last three quarters of 1969 strikes in Canada sharply reduced exports of iron ore, steel, nickel and shipments of commodities through British Columbia ports. In the early months of 1970 exports were boosted by the pent-up demand for these commodities. Later in the year labour disputes curtailed exports of forest products, aluminum and automotive products. As

MERCHANDISE TRADE

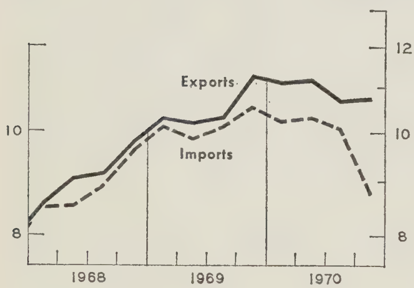
Quarterly — Billions of Dollars

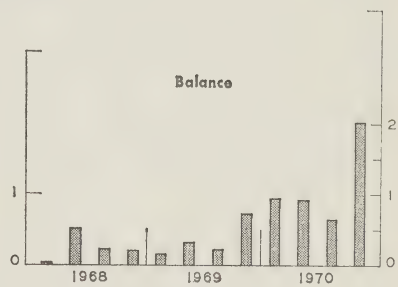
TOTAL



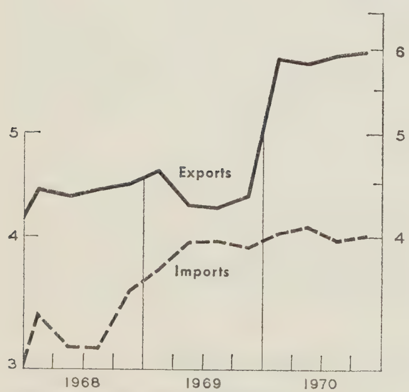


WITH THE UNITED STATES

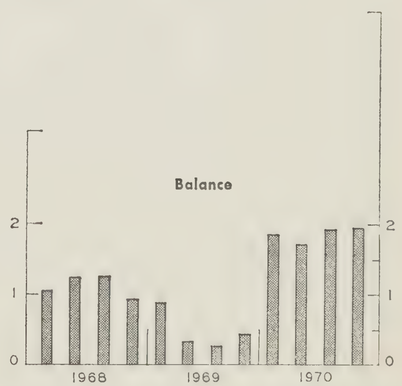




WITH OTHER COUNTRIES



Seasonally adjusted at annual rates.



a result, most of the growth in exports in 1970 was concentrated in the first quarter of the year, but the demand for Canadian exports thereafter remained strong. Accelerating export prices contributed to the increase in the value of exports in the first five months of the year, but thereafter the rise in the exchange rate more than offset the increase in the foreign prices of our exports until late in the year.

The strong growth in exports from 1969 to 1970 was shared by most types of Canadian exports; indeed, the only major exporters not recording substantial increases were the forest products, aluminum and automobile industries, and exports of all these industries were affected not only by somewhat weaker foreign demand but also by serious work stoppages. Shipments of nickel rose by $350 million, reflecting the post-strike catch-up, very strong world demand and a substantial increase in price. A high rate of shipments of iron, steel and copper was resumed in 1970, following the strike disruptions of the previous year. With the easing of restrictive quotas in the United States, sales of oil and gas rose sharply. Shipments of wheat and flour, which had dropped by about $200 million in 1969, regained their 1968 level, as poor weather reduced crops in several major producing countries. The market for coarse grains was also strong in 1970. Another substantial increase was recorded in exports of manufactured goods other than automotive products, but automotive exports rose very little because of the weak car market in North America early in the year and the strike in the autumn.

Demand from overseas markets for Canadian exports was extraordinarily strong in 1970. Shipments to Britain, which had shown no significant increase after the early 1960s, rose by 34 per cent. About a quarter of the increase was in nickel, and the remainder reflected the growing demand for industrial materials and the gradual easing of the British measures designed to restrain imports. Exports to the buoyant economies of continental Europe rose by 34 per cent and to Japan by 27 per cent. Shipments to other overseas countries rose by 38 per cent, with more than one third of the increase being in wheat exports.

Demand from the United States for Canadian exports was well maintained in 1970 despite the marked slowdown in the rate of growth in the U.S. economy. Total Canadian exports to that market rose by 4 per cent; non-automotive exports increased by 6 per cent. Valued in U.S. dollars, non-automotive exports rose by 9½ per cent, whereas total imports into the United States increased by 11 per cent.

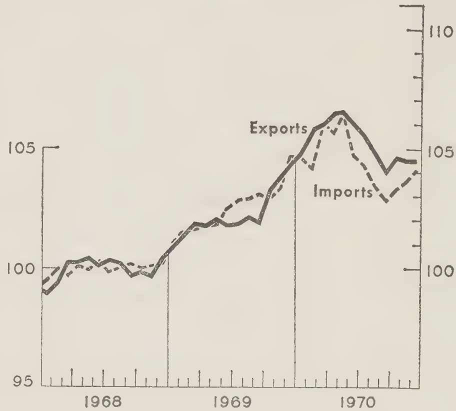
The value of merchandise imports declined by 1 per cent in 1970, following an increase of 15 per cent in 1969. Imports of automotive products, which had risen sharply in 1969 and earlier years, fell by 11 per cent in 1970; they

remained at about the 1969 levels in the first three quarters of the year, then dropped off sharply during the strike in the fourth quarter. Imports of other commodities rose by 2 per cent in 1970, somewhat less than the growth in domestic demand. Imports of consumer goods accounted for most of the small increase, while imports of machinery and industrial materials were only slightly higher than in 1969.

In the latter part of 1969 and the first five months of 1970 both export and import prices rose very rapidly. As the Canadian exchange rate began to appreciate in June, both export and import prices fell, but there was some upturn during the fourth quarter of the year. By the end of the year, import prices on average were slightly lower than a year earlier while export prices were very slightly higher.

CANADIAN TRADE PRICE INDEXES

Index 1968=100



The surplus on Canada's merchandise trade rose by $2,142 million in 1970, after falling by $515 million in 1969. The balance with all our major trading partners improved considerably.

The deficit on non-merchandise transactions rose by $94 million from 1969 to 1970 to reach $1,705 million. Sharply increased interest and dividend payments and official foreign aid contributions were partly offset by substantially higher interest receipts, chiefly from increased earnings on the higher average level of official international reserves, and increased freight and shipping receipts. The deficit on travel payments increased slightly, the result of a growing deficit on overseas travel offset in part by a somewhat larger surplus on the travel account with the United States.

As a result of these developments in merchandise and non-merchandise trade, Canada's current account balance, which had moved from a deficit of $107 million in 1968 to a deficit of $751 million in 1969, swung to a surplus of $1,297 million in 1970. Of the $2,048 million improvement in 1970, $779 million was in transactions with the United States and $1,282 million with overseas countries, and there was a decline of $13 million in gold production available for export.

CURRENT ACCOUNT OF THE BALANCE OF PAYMENTS

(millions of dollars)

	1968	1969	1970
With the United States			
Merchandise trade: exports	9,116	10,499	10,953
imports	8,867	10,132	9,811
balance	249	367	1,142
Non-merchandise trade balance	−1,170	− 1,208	− 1,204
Current account balance	− 921	− 841	− 62
With other countries			
Merchandise trade: exports	4,421	4,375	5,888
imports	3,295	3,882	4,028
balance	1,126	493	1,860
Non-merchandise trade balance	− 432	− 511	− 596
Current account balance	694	− 18	1,264
of which:			
with Britain	466	323	764
OECD Europe	− 237	− 341	− 29
other countries	465	—	529
Gold production available for export	120	108	95
Total current account balance	− 107	− 751	1,297

CAPITAL ACCOUNT

The dramatic shift in the current account balance in 1970 was accompanied by sharply reduced inflows of capital and a large increase in official international reserves. Net inflows of long-term capital were $1,443 million lower than in 1969, but net outflows of short-term capital were $860 million less and so the net inflow of capital in all forms declined by $583 million.

SUMMARY OF THE BALANCE OF PAYMENTS

(millions of dollars)

	Annual		
	1968	1969	1970
Current account balance	– 107	– 751	1,297
Capital flows			
Long-term capital	1,654	2,257	814
Short-term capital	–1,198	–1,441	– 581
Total	456	816	233
Allocation of Special Drawing Rights	—	—	133
Increase in official international reserves	349	65	1,663

Sales of new issues of Canadian bonds to non-residents were still the most important source of long-term capital inflows in 1970, though they were substantially lower than the very high levels reached in 1968 and 1969. Although the interest cost to Canadians of new borrowings in the United States market has been as high as or higher than in the Canadian market since late 1969, some borrowers with large financing programmes have continued to make use of external sources of capital. However, new offerings of bonds in the United States were appreciably reduced after the first quarter, and this tendency was reinforced by the official request made of Canadian borrowers in October that they explore carefully the possibility of doing their necessary financing in the Canadian market before having recourse to markets abroad. Deliveries of bonds in 1970 were about $350 million larger than offerings because of deferred deliveries of bonds offered earlier. Even so, total deliveries to United States residents dropped to $1,004 million in 1970 from about $1,300 million in 1968 and in 1969, with a large part of the 1970 deliveries being concentrated in the first quarter. The interest-rate incentive to place bond issues in Europe diminished in 1970 and very few issues were offered after Euro-bond rates rose temporarily in the second quarter. Deliveries of new issues in Europe, which had exceeded $500 million in 1968 and in 1969, dropped to $192 million in 1970. Retirements of Canadian bonds held by non-residents rose by $79 million to total $474 million in 1970.

Much of the remainder of the decline in net long-term capital inflows in 1970 resulted from a shift in trade in Canadian equities. In 1969 Canadians had raised substantial sums in the United States through the sale of new issues of corporate stocks, but in 1970 such sales were relatively small. On balance in 1969 Canadians had sold outstanding Canadian stocks to foreigners, but in 1970

CAPITAL FLOWS

(millions of dollars)

	Annual			Semi-annual 1970	
	1968	1969	1970	I	II
Foreign direct investment in Canada	590	655	760	355	405
Canadian direct investment abroad	−225	−255	−215	−170	−45
Canadian stocks: net new issues	62	212	73	44	29
trade in outstandings	114	53	−155	−87	−68
total	176	265	−82	−43	−39
Canadian bonds: gross new issues to U.S. residents	1,335	1,288	1,004	554	450
others	515	566	192	145	47
total	1,850	1,854	1,196	699	497
retirements	−426	−395	−474	−326	−148
trade in outstandings	−70	2	−40	−22	−18
total	1,354	1,461	682	351	331
Foreign securities	−467	106	61	192	−131
All other long-term capital	226	25	−392	−85	−307
Total long-term capital	1,654	2,257	814	600	214
Total short-term capital	−1,198	−1,441	−581	268	−849
Total capital flows	456	816	233	868	−635

they bought Canadian stocks from foreigners. Canadians continued to reduce their holdings of foreign equities in the first half of 1970 but became net buyers again in the second half. After two years in which transactions related to export credits gave rise to only small net capital flows, advances for export credit financing rose markedly in 1970, producing a capital outflow. Foreign direct investment in Canada rose by \$105 million while Canadian direct investment abroad declined by \$40 million.

Short-term capital flows responded to the marked change in interest rates abroad in 1970. Compared with 1969, when the very high interest rates offered for funds placed on deposit in the United States and Europe attracted a heavy volume of short-term capital from Canada, interest rates in foreign markets were appreciably lower in 1970 and outflows from Canada were much smaller. In

fact, during the spring, when the Canadian dollar was under some speculative pressure, there were substantial short-term capital inflows, but outflows resumed in the second half of the year.

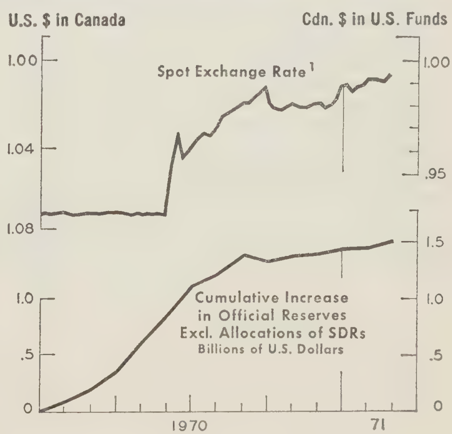
The foreign currency operations of the chartered banks gave rise to a net outflow from Canada of $122 million. In 1969 the net outflow was $506 million. In 1970 Canadians continued to place short-term funds abroad through other channels, though the flows were much smaller than in 1969. At the same time yields on hedged short-term finance company and commercial paper issued by Canadian borrowers continued to be higher than on comparable investments in the United States and non-residents added further to their holdings of Canadian paper. The balancing item in the balance-of-payments statistics, which is the difference between the direct estimates of the current and capital accounts, is included with short-term capital outflows and again represented large unidentified net payments to non-residents in 1970.

EXCHANGE RATE AND OFFICIAL RESERVES

In the first five months of 1970 the combined strength of the current and capital accounts put upward pressure on the Canadian dollar and Canada's official international reserves rose sharply. When the maintenance of the official parity margins was suspended at the end of May, reserves were U.S. $853.4 million higher than they had been at the beginning of the year, excluding the initial allocation of SDRs amounting to U.S. $124.3 million. In addition, U.S. $360 million had been acquired for future delivery so that the combined increase in spot and forward positions, excluding the SDR allocation, was about U.S. $1.2 billion.

The exchange rate of the Canadian dollar rose sharply at the beginning of June after the parity limits were abandoned. By the end of the month the Canadian dollar had appreciated by more than 3½ per cent, and by the end of December it had risen to 98.89 U.S. cents, an appreciation of 6 per cent. From the end of May to the end of December official reserves rose by U.S. $595 million, including U.S. $360 million delivered under forward contracts undertaken before the end of May. A substantial part of the increase excluding deliveries on maturing

EXCHANGE RATE AND OFFICIAL RESERVES

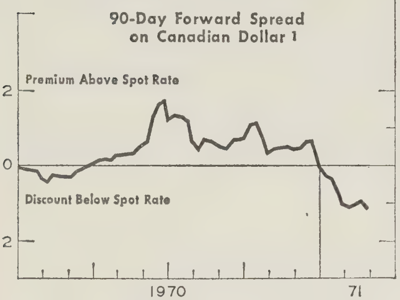


1. Weekly average of noon rates.

forward contracts occurred at the beginning of June. On January 1, 1971 Canada's reserves were augmented by the receipt of its share of the second allocation of SDRs in the amount of U.S. $117.7 million. Reserves rose a further U.S. $53.6 million to the end of February and the exchange value of the Canadian dollar at that time was 99.32 U.S. cents.

FORWARD EXCHANGE RATE

Expressed as a Per Cent per Annum



1. Weekly average of noon rates.

The forward exchange rate for the Canadian dollar was at a small discount early in the year, moved to a large premium in June and remained at an appreciable premium until late in the year. It then fell sharply and was at a considerable discount by February.

As part of the quinquennial revision of IMF quotas, Canada's quota was increased at the end of 1970 from the equivalent of U.S. $740 million to U.S. $1,100 million. In accordance with IMF procedure 25 per cent of this increase was paid in gold and 75 per cent in Canadian dollars. This transaction increased Canada's reserve position in the IMF and reduced official holdings of gold, but it did not affect the total holdings of reserves.

OFFICIAL INTERNATIONAL RESERVES

(month-ends — millions of U.S. dollars)

	Dec. 1968	Dec. 1969	May 1970	Dec. 1970	Feb. 1971
Foreign currencies					
U.S. dollars	1,964.9	1,743.6	2,526.3	3,022.1	3,076.6
Other currencies	11.6	12.3	17.4	14.5	13.1
Gold	863.1	872.3	879.5	790.7	791.2
Special Drawing Rights	–	–	138.1	182.1	299.8
Reserve position in the IMF	206.2	478.1	522.5	669.6	669.6
Total	3,045.8	3,106.3	4,084.0	4,679.0	4,850.3

Appendix Tables I to IV ▶

APPENDIX TABLE I

BANK OF CANADA ASSETS AND LIABILITIES

(monthly changes — millions of dollars)

	Government of Canada securities at book value	Net foreign currency assets	Investment in IDB	All other assets (net)	Note circulation	Canadian dollar deposit liabilities: Chartered banks	Government of Canada	Other
1970								
Jan.	−110	− 59	+ 6	− 6	−219	+108	− 68	+ 9
Feb.	− 13	− 36	+ 4	− 35	− 8	− 78	+ 18	−12
Mar.	− 53	+110	+ 4	− 35	+ 70	− 19	− 29	+ 5
Apr.	+ 70	− 25	+14	+ 19	+ 20	− 18	+ 82	− 7
May	− 51	+ 23	+ 4	+ 52	+ 44	+ 16	− 35	+ 2
June	+ 6	+ 48	+ 4	+ 84	+118	− 31	+ 57	− 3
July	+121	−104	+ 4	− 23	+ 38	+ 19	− 67	+ 9
Aug.	+ 30	+ 5	+ 3	− 54	− 52	− 5	+ 52	−13
Sept.	− 20	–	+ 2	− 41	–	− 42	− 15	− 2
Oct.	− 7	+ 5	+14	+ 31	− 20	+ 36	+ 17	+ 8
Nov.	+ 66	− 11	+ 3	− 31	+ 38	+ 19	− 25	− 4
Dec.	+144	+ 69	+ 5	+161	+157	+ 62	+159	+ 2
Total	+183	+ 25	+66	+122	+186	+ 68	+147	− 4

APPENDIX TABLE II

BANK OF CANADA NET TRANSACTIONS IN GOVERNMENT OF CANADA SECURITIES IN 1970

(delivered basis — par value in millions of dollars)

	Net purchases from (+) or net sales to (−) investment dealers and banks						
		Bonds[1]					
	Treasury bills	3 years & under	3 years to 5	5 years to 10	Over 10 years	Sub-total bills and bonds	Securities under PRA
Jan.	+ 19	–	–	–	–	+ 19	−37
Feb.	− 1	+ 5	−29	–	–	− 24	–
Mar.	− 25	+ 2	− 2	− 1	–	− 26	–
Apr.	+ 1	–	+ 5	+ 1	+ 5	+ 11	+31
May	+ 8	−25	+36	+ 7	+10	+ 35	−31
June	+ 8	−16	–	–	+ 1	− 7	+30
July	+ 85	−15	−46	–	–	+ 24	−20
Aug.	+ 4	–	–	− 1	–	+ 3	+ 7
Sept.	+ 7	–	–	–	–	+ 7	−17
Oct.	+ 4	–	–	+ 3	–	+ 7	–
Nov.	+ 10	–	–	–	+ 5	+ 15	–
Dec.	+126	+32	− 8	−18	–	+133	+ 7
Total	+246	−17	−43	− 9	+21	+198	−30

(1) Classified by years to maturity at time of transactions.

Net transactions with Government and other client accounts								
Purchases (+) of new issues less matured holdings		Net purchases from (+) or net sales to (−)				Net change in holdings of Government of Canada securities		
		Securities Investment Acct.		Other Government and client accounts				
bills	bonds	bills	bonds	bills	bonds	bills	bonds	total
+ 22	–	–	−50	− 64	− 2	− 35	−77	−112
+ 17	+ 6	–	–	− 6	− 5	+ 10	−23	− 13
+ 14	–	–	–	− 42	− 3	− 52	− 4	− 56
+ 23	–	–	+50	− 43	− 2	− 15	+85	+ 70
–	+ 21	–	−11	− 36	−24	− 35	−12	− 47
+ 8	–	–	–	− 26	− 1	+ 6	− 1	+ 5
+129	+ 58	–	–	− 59	− 7	+144	−19	+125
− 10	+ 50	–	–	− 27	+ 4	− 28	+56	+ 28
− 7	–	–	–	− 5	− 1	− 13	− 9	− 22
+ 23	–	–	–	− 35	− 4	− 8	− 1	− 9
+ 77	–	–	–	− 19	− 2	+ 68	+ 3	+ 71
+ 48	+ 44	–	–	− 74	−14	+102	+42	+144
+342	+179	–	−11	−435	−60	+144	+39	+183

APPENDIX TABLE III

GOVERNMENT OF CANADA FINANCIAL ACCOUNTS

(millions of dollars)

	Calendar 1968	Calendar 1969	Calendar 1970
1. Budgetary surplus (—) or deficit	733	—609	166
Adjustments for national accounts basis:			
Funds borrowed (—) from:			
Public service superannuation accounts	—508	—565	—654
Unemployment insurance and old age security funds	— 87	—131	172
All other adjustments to national accounts basis (net)	—105	532	328
2. National accounts basis surplus (—) or deficit	33	—773	12
3. Increase in major loans and advances to:			
Central Mortgage and Housing Corporation	394	468	552
Farm Credit Corporation	131	96	57
CNR (incl. Air Canada, excl. debt refunding)	130	116	120
Export Development Corporation	42	35	51
Municipal Development and Loan Fund	7	— 7	— 9
Canadian Broadcasting Corporation	12	15	14
1967 World Exhibition (incl. guaranteed notes)	8	–	–
National governments	61	37	88
Provincial governments	61	23	28
Other	50	45	54
Sub-total	896	828	955
4. Canadian dollars required to finance increase in Government's foreign currency assets (or reduction in liabilities):			
Advances to the Exchange Fund	529	—207	1,399
Holdings of IBRD and Columbia River Treaty bonds	— 78	— 32	— 32
Subscriptions and advances to international agencies	30	30	395
Foreign-pay securities (outside Gov't accounts)	—266	— 14	121
Demand notes payable to international agencies	—229	229	—301
Sub-total	— 14	6	1,582
5. Funds required for net increase in other assets or reduction in other liabilities (1):			
Refundable corporation tax	82	110	44
Excess of accrued corporation income tax over collections (2)	214	—475	—405
All other assets and liabilities	—162	— 93	—281
Sub-total	134	—458	—642
6. Total Canadian dollar financing requirements (sum of items 2, 3, 4 and 5)	1,049	—397	1,907
7. Total Canadian dollar financing requirements were met by:			
Increase (+) in Canadian dollar securities outside Government accounts	1,109	278	1,992
Reduction (+) in Canadian dollar cash balances	— 60	—675	— 85
Total (= Item 6)	1,049	—397	1,907

(1) Apart from those shown in Item 7.

(2) A contra amount is included in "All other adjustments to national accounts basis (net)" shown in Item 1.

APPENDIX TABLE IV

MAJOR SOURCES OF FINANCING: FEDERAL, PROVINCIAL AND MUNICIPAL GOVERNMENTS AND THEIR ENTERPRISES*

(millions of dollars)

	1968	1969	1970
Government of Canada			
Increase in securities outside Gov't accounts:			
treasury bills	360	67	720
Canadian-pay market bonds	709	— 113	558
Canada Savings Bonds	40	324	714
Sub-total(1)	1,109	278	1,992
Increase (—) in Canadian dollar cash balances	— 60	— 675	— 85
Total(1)	1,049	— 397	1,907
Provincial and Municipal Governments			
Increase in outstanding Canadian-pay bonds:			
purchased by Canada and Quebec Pension Plan funds	864	1,005	1,062e
other Canadian dollar issues	454	209	712
Increase in loans from:			
chartered banks	— 3	54	— 35
Government of Canada (including CMHC and MDLF)	241	149	244
Increase in provincial short-term paper outstanding	30e	— 30e	— 10e
Increase in foreign currency issues outstanding	904	1,021	371
Total provincial-municipal borrowing(2)	2,490	2,408	2,344

e: Estimate.

* To obtain a total of combined federal, provincial and municipal financing without double counting, loans from the Government of Canada to the provinces and municipalities would have to be eliminated, as well as changes in provincial-municipal holdings of Government of Canada securities.

(1) Excluding net new foreign currency issues of the Government of Canada which during 1968, 1969 and 1970 were +266, +14 and —121 respectively.

(2) To the extent that we have not been able to identify purchases by provincial government accounts of provincial or municipal securities the total of provincial-municipal financing is overstated.

BANK OF CANADA STATEMENT OF INCOME AND EXPENSE

YEAR ENDED DECEMBER 31, 1970
(with comparative figures for 1969)
(thousands of dollars)

	1970	1969
Income		
On investments, including deposits	$274,146	$247,223
Other income	203	227
	$274,349	$247,450
Expense		
Salaries(1)	$ 7,563	$ 6,899
Contributions to pension and insurance funds	1,877	715
Other staff expenses(2)	560	469
Directors' fees	28	27
Auditors' fees and expenses	105	104
Taxes — municipal and business	1,475	1,377
R.C.M.P. guards and security protection	278	265
Bank note costs	7,611	5,043
Data processing and computer costs	486	425
Maintenance of premises and equipment — net	1,148	979
Printing and other costs of publications	157	125
Other printing and stationery	262	265
Postage and express	274	269
Telephones and telegrams	268	246
Travel and staff transfers	344	247
Interest on unclaimed balances	83	75
Other expenses	361	270
	$ 22,880	$ 17,800
Depreciation of buildings and equipment	1,176	915
Net Income Paid to Receiver General for Canada	250,293	228,735
	$274,349	$247,450

(1) The number of staff averaged 1,106 in 1970 and 1,065 in 1969.
(2) Includes overtime pay, medical services and cafeteria expenses.

ASSETS

	1970	1969
Deposits in foreign currencies:		
Pounds sterling and U.S.A. dollars	$ 57,750	$ 79,134
Other currencies	203	247
	57,953	79,381
Cheques on other banks	335,697	88,924
Advances to chartered and savings banks	—	900
Accrued interest on investments	64,416	60,417
Bills bought in open market, not including treasury bills, at cost	—	2,580
Investments — at amortized values:		
Treasury bills of Canada	621,193	477,687
Other securities issued or guaranteed by Canada maturing within three years	1,702,569	1,929,646
Other securities issued or guaranteed by Canada not maturing within three years	1,917,503	1,650,476
Debentures issued by Industrial Development Bank	415,599	351,344
Securities issued by the United Kingdom and the United States of America	136,534	81,233
Other securities	2,633	—
	4,796,031	4,490,386
Industrial Development Bank:		
Total issued share capital, at cost (note)	54,000	52,000
Bank premises:		
Land, buildings and equipment Cost less accumulated depreciation	28,580	24,152
Net balance of Government of Canada collections and payments in process of settlement	64,785	88,165
Other assets	3,527	1,401
	$5,404,989	$4,888,306

Note: The audited financial statements of the Industrial Development Bank as of September 30, 1970 show an equity of $74,240,425 at which date the Bank of Canada's investment in the share capital was $53,000,000.

L. RASMINSKY, Governor
Ottawa, Canada, January 28, 1971.

A. J. NORTON, Chief Accountant

AS AT DECEMBER 31, 1970
(with comparative figures as at December 31, 1969)
(thousands of dollars)

LIABILITIES

	1970	1969
Capital paid up	$ 5,000	$ 5,000
Rest fund	25,000	25,000
Notes in circulation	3,632,317	3,446,176
Deposits:		
Government of Canada	227,968	80,931
Chartered banks	1,176,434	1,108,815
Other	37,951	42,030
	1,442,353	1,231,776
Liabilities in foreign currencies:		
Government of Canada	32,255	22,688
Other	332	953
	32,587	23,641
Bank of Canada cheques outstanding	264,981	155,022
Other liabilities	2,751	1,691
	$5,404,989	$4,888,306

Auditors' Report • We have examined the statement of assets and liabilities of the Bank of Canada as at December 31, 1970 and the statement of income and expense for the year then ended. Our examination included a general review of the accounting procedures and such tests of accounting records and other supporting evidence as we considered necessary in the circumstances.

In our opinion these financial statements present fairly the financial position of the Bank as at December 31, 1970 and the results of its operations for the year then ended.

A. JOHN LITTLE, F.C.A.
of Clarkson, Gordon & Co.

MAURICE SAMSON, C.A.
of Samson, Bélair, Côté, Lacroix et Associés

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BANK OF CANADA
245 SPARKS STREET
OTTAWA, ONTARIO
K1A 0G9

BANK OF CANADA

ANNUAL REPORT OF
THE GOVERNOR TO THE
MINISTER OF FINANCE

AND STATEMENT OF ACCOUNTS

FOR THE YEAR 1971

Bank of Canada • Banque du Canada Ottawa K1A 0G9

February 29th, 1972.

The Hon. John N. Turner, P. C.,
Minister of Finance,
Ottawa, Ontario.

Dear Sir,

In accordance with the provisions of the Bank of Canada Act I am transmitting herewith my report for the year 1971 and a statement of the Bank's accounts for this period which is signed and certified in the manner prescribed in the by-laws of the Bank.

Yours very truly,

W. Rasminsky

Governor

BANK OF CANADA

Report of the Governor — 1971

Some Highlights of the Year

The Canadian economy expanded strongly in the course of 1971 but unemployment remained high. For a time major disturbances in the international trade and payments system appeared to threaten our economic advance, but by the end of the year marked progress had been made in removing some of the most serious uncertainties. We have entered 1972 with more than a year of firm growth behind us and with the prospect that this will continue.

Since the early months of 1970 the primary emphasis in economic policy has been on encouraging expansion. Monetary and fiscal policy have been set to promote rising levels of output and this continues to be their present posture. On the monetary side the usual indicators, whether interest rate levels, aggregate flows of credit in Canada or holdings of various monetary and other highly liquid assets, reflect the ease of credit conditions.

Output in Canada has responded to the impetus given by fiscal and monetary policy over the past two years, though not all sectors have shared equally in the stronger pace of expansion, and the current account in our international transactions has recently moved from surplus to deficit. In real terms the Gross National Product has been rising at an average rate of 6 per cent a year since the third quarter of 1970—a rate in excess of the long-term growth path of the Canadian economy. This is a considerable achievement in the light of the rather hesitant character of the economic expansion in the United States.

Despite the large increase in output and a rise in employment which exceeded 3 per cent in the course of 1971, the seasonally adjusted rate of unemployment in January 1972, though down from its highest levels, was still in excess of 6 per cent. The persistence of high unemployment has been a source of general concern, and on many fronts economic policies continue to be directed towards relief of the problem. Another matter of concern is that the pace of cost increases remains high and price increases have become somewhat larger in recent months.

MONETARY POLICY

At the beginning of 1971 the easy state of credit conditions that had developed in Canada during the previous year was clearly evident. Both long-term and short-term interest rates were well below the high levels reached a

year earlier. Total bank assets had been rising at a pace that enabled the banks to add to their holdings of liquid assets and at the same time to accommodate rising loan demands. Increases in both the total of currency and chartered bank Canadian dollar deposits and in the general public's holdings (i.e., excluding Government deposits) had accelerated during 1970, and the rapid expansion of the banking system had been accompanied by easier conditions and larger flows of credit throughout the financial system. Thus, mortgage lending had picked up sharply and a high volume of long-term securities was being sold in the Canadian market.

Credit conditions remained easy in 1971. Although most interest rates moved up from the low points touched in the first quarter, they declined in the last few months of the year, and at the end of 1971 were at roughly the same levels as in the early part of the year. This occurred despite the very large borrowing requirements of the federal and provincial governments and the rising credit demands of other borrowers. The movement of interest rates in Canada reflected a number of forces, including broadly similar interest rate developments in the United States. The Bank of Canada's operations were, of course, an important influence enabling the rising credit demands of both the public and private sectors of the economy to be accommodated without sustained upward pressure on interest rates.

Developments in Canada's external payments, as well as in world payments as a whole, had an important impact on our situation and therefore on the management of economic policies. In the prevailing circumstances, I regarded it as an important policy objective to avoid contributing to undue appreciation of our currency. This would have exacerbated the difficulties of important export and import-competing industries and impeded the expansion of economic activity.

The problem of adjusting to changes in our balance of payments is not a new one. In the latter part of the 1960s there had been a tendency in Canada for the deficit on current account to decline and for the inflow of long-term capital to rise. As a result, our combined current and long-term capital accounts showed large surpluses, which were mainly offset by outflows of short-term capital. During 1970 a sharp improvement in our trade position was reflected in a swing on current account to a surplus of over $1 billion from a deficit of nearly $1 billion in the preceding year. In 1971 the current account balance, though considerably reduced, was still in surplus to the extent of $225 million. Following on the earlier strengthening of our basic position to which I have referred, the change presented Canada with the major challenge of bringing about the necessary adjustment in the pattern of capital flows. Whatever the future may hold—and there are signs that a deficit on current account is re-emerging—it was the case in 1970 and to a lesser extent in 1971 that the surplus on

current account implied the need for an offsetting net export of capital, or an increase in exchange reserves, or a rise in the level of the Canadian dollar in the exchange market. In the event, the accommodation to our changed external situation included all three elements. The value of the Canadian dollar rose and we added to our foreign reserves, but a large part of the adjustment was accomplished by a shift in our international capital movements. This shift in turn necessitated major changes in the scale and structure of financial flows within Canada. The magnitude of what was needed, and of what was in fact accomplished, is impressive. In 1971 provinces, municipalities and business corporations raised a total of \$3.5 billion by net new issues of bonds in the market. Of this amount, only \$0.4 billion was in the form of foreign currency issues. Two years earlier when net new bond issues of these borrowers totalled \$2.1 billion, the net issue of foreign currency bonds was \$1.4 billion. Thus the sales of Canadian dollar issues rose from \$0.7 billion in 1969 to \$3.1 billion in 1971.

The adjustment in our international capital account was assisted by the relatively easy credit conditions encouraged by Bank of Canada policies. These conditions facilitated the placement of long-term securities in the Canadian market and the transfer of financial business from foreign markets. This whole process has involved a substantial increase in financial intermediation in Canada, that is, increased borrowing and lending through financial institutions. Since a large part of financial intermediation occurs in the banking system, the process naturally contributed to the high rate of increase in the monetary aggregates which occurred last year.

The change in our capital account, which was necessary if pressure on the exchange rate was to be mitigated, was also helped by the response of Canadian borrowers to the request by the Minister of Finance that they explore carefully the potentialities of the Canadian market before offering securities for sale abroad. I continue to support that request and appreciate the response to it.

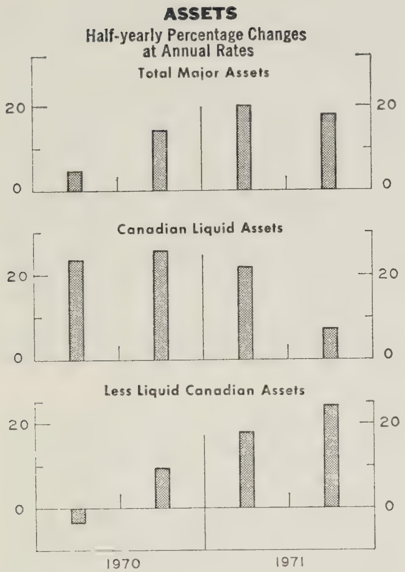
In the first few months of 1971 interest rates remained low in Canada. The exchange value of the Canadian dollar was rising during this period, and in February it reached the highest point since it had been freed at the end of May 1970. In February 1971 Bank Rate was reduced in two steps from 6 per cent to 5¼ per cent and there was a further decline in short-term interest rates. Meanwhile, interest rates in the United States started to move up and continued to rise through mid-year. They also rose in Canada but the increase in short-term rates began later and was less rapid than in the United States. This development offered some relief on the exchange rate side as it reduced the incentive for capital to move to Canada. During the second quarter, particularly in June, there was a decline in the exchange value of the Canadian dollar. By this time, the buildup of liquidity in the banks and elsewhere in the system had proceeded

to a point where the Bank felt that some alteration in the stance of monetary policy could safely be made without fear that any lack of credit would dampen the economic expansion in progress. Therefore, looking to the future, the Bank adopted a somewhat less easy posture in the management of cash reserves towards the end of the second quarter in order to slow down the rapid accumulation of liquid assets by the banks.

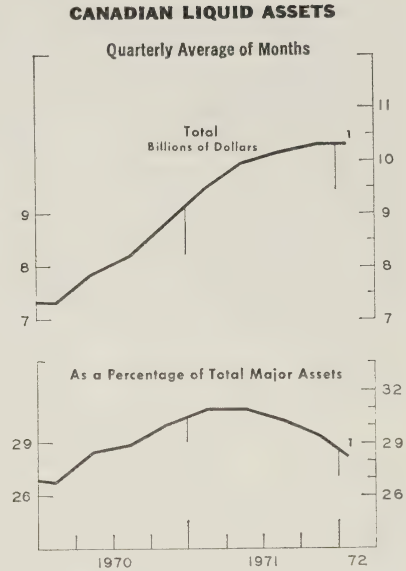
The announcement on August 15 of new policies to deal with the external and domestic problems of the United States economy injected a new element into the international economic situation. An immediate impact on Canada was to weaken confidence in our economic prospects, and this at a time when the unemployment rate was high and, as events were to prove, was to go higher still. In the light of this concern and of renewed upward pressure on the exchange rate (which reflected in part declining interest rates in the United States) the Bank of Canada welcomed and encouraged the tendency of interest rates in Canada to follow the downward trend that had begun in the United States in August. Bank Rate was reduced from 5¼ per cent to 4¾ per cent on October 25, and by year-end both long-term and short-term interest rates had declined substantially.

Over the year 1971 as a whole, as I have indicated, chartered bank assets as well as the public's holdings of monetary and other highly liquid assets increased very rapidly. For example, total currency and Canadian dollar deposits at chartered banks were 18 per cent higher in December 1971 than a year earlier and the increase in private holdings of currency and Canadian dollar bank deposits was 15 per cent. This rate of growth of the banking system was clearly larger than would be consistent over any prolonged period with sustainable balanced growth of the Canadian economy. But in the circumstances of 1971 any appreciably less rapid expansion would have had effects on the cost and availability of credit and on the exchange rate that would have risked a dampening of economic activity. An "evenhanded" approach, designed to achieve some particular rate of growth of any given monetary aggregate that might be sustainable over the years, would not have been helpful.

During the past year or more bank loans have been rising very rapidly. Since the middle of 1971 Bank of Canada policy has been such that the banks have not been able, by and large, also to add to their liquidity as they had done over the previous year and a half. The reductions by the Bank of Canada in both December 1971 and January 1972 of the chartered banks' secondary reserve requirement did not represent a departure from the policy of containing bank liquidity; rather these changes were of a technical nature as is explained in a later section of this Report. The monetary expansion that has occurred since the middle of 1971 has reflected very largely the increase in bank loans and other less liquid assets, and owes little to an increase in the banks' holdings of liquid assets. This is illustrated in the accompanying charts, which show that while



Seasonally adjusted.



Seasonally adjusted.
1. Average of January-February 1972, preliminary figures.

total bank assets increased almost as rapidly in the second half of 1971 as in the first half, the increase in the banks' holdings of liquid assets tapered off markedly, and that the ratio of these assets to total assets declined after the middle of the year.

The trend of bank liquidity is of course subject to Bank of Canada policy, but changes in the banks' liquid assets over the years are affected to an important degree by the size of Government of Canada financing requirements and by the extent to which these are met by sales of marketable securities. The large sales of marketable bonds together with increases in the amount of treasury bills outstanding in 1970 and the first half of 1971 were an important factor in the increase in bank liquidity during that period. By the same token, the success of the Canada Savings Bond campaign during the autumn of 1971 greatly facilitated the task of the central bank in keeping bank liquidity under appropriate control.

It continues to be the objective of the Bank to encourage sustained economic expansion and a reduction in unemployment in Canada, and to ensure that this objective is supported by an adequate degree of monetary expansion. We continue also to be mindful of the risks of inflation that would be involved if we approached the zone of full utilization of our resources with an excessive amount of liquidity in the economy.

SOME PROBLEMS OF ECONOMIC MANAGEMENT

As I have already indicated, the emphasis of economic policy in the past two years has been placed on expanding output and creating jobs. Important progress has been made but more remains to be done.

Unemployment has remained disappointingly high. In 1971 the economy was still in the early phase of a cyclical expansion, a phase in which employers tend to meet increasing demands for their output by making more efficient use of their work force rather than by taking on additional employees. This tendency was no doubt reinforced by the continued high rate of cost inflation. The task of providing adequate job opportunities is particularly pressing in Canada owing to the rapid trend of labour force growth—more rapid than in other industrial countries—and particularly difficult by reason of the fact that this growth has involved a change in the structure of the labour force, with the entry of a substantially larger number of young inexperienced people.

The persistence of inflation is also a disquieting feature of our economic performance. It is true that over the past two years as a whole our price levels have risen less than those of any other industrial country. In 1971, particularly in the first half of the year, we had the benefit of a cyclical increase in productivity such as normally occurs at the beginning of periods of strong expansion, and it will not be possible to achieve an improvement in price behaviour unless the rates of cost increase also moderate. Despite almost two years of high unemployment and unused industrial capacity, a significant appreciation of the Canadian dollar, and the work of the Prices and Incomes Commission, there has not yet been enough moderation of costs to ensure a further slowing of price inflation. Indeed, some recent evidence discussed later in this Report seems to point in the other direction.

It is clearly not an easy matter to reconcile reasonable price stability with high employment over an appreciable period of time and no country has found the answer. The problem has been made more difficult by the persistence of price increases over a number of years, which has given rise to widely held expectations of further inflation. Obviously, such expectations greatly increase the time required for costs and prices to respond to an easing of demand pressures. The high rate of inflation in the United States and other major industrial countries has added to our problem, and our task may be made easier in the future if the recent improvement in price performance in the United States and in some other countries is sustained.

In respect of economic policy, the Standing Senate Committee on National Finance in its report on "Growth, Employment and Price Stability" emphasized that because there are long lags between policy action and the response of the economy, policy must anticipate the future course of the economy and not be set simply in response to the immediate situation. For the same reason, as the

Committee said, there are no "instant solutions" for economic problems. The Committee stressed that a broad understanding of these unavoidable facts of life—as well as a realistic setting of our economic objectives—would assist greatly in the formulation and in the acceptance of sound policy. I fully agree, and have frequently pointed out that economic policy must be prepared to move in either direction, with due regard for the lags involved in its impact on the economy.

The task of monetary policy is to contribute as much as it can to the forward-looking management of aggregate demand in the economy. It may be that demand management will be found to need assistance from supplementary policies, such as price-incomes policies; but whether or not this proves to be the case good demand management will always be a necessary condition for the achievement of our economic objectives.

THE INTERNATIONAL MONETARY SYSTEM

The pressures of mounting imbalance in the international payments system erupted on August 15 with the announcement of the suspension of convertibility into gold of official holdings of U.S. dollars and a 10 per cent surcharge on dutiable imports into the United States.

At the core of the international monetary problem was a vast deterioration in the international trade position of the United States and continued large exports of long-term capital. This disequilibrium had been growing rapidly for several years. It was accompanied by large flows of short-term capital generated by international differences in interest rates. As the size of the U.S. deficit grew and confidence in the existing structure of exchange rates eroded, these short-term capital movements were greatly augmented by flows of a speculative character.

Following the U.S. announcement most of the world's main currencies were forced to follow those of Germany, the Netherlands and Canada in floating. However, on December 18 agreement was reached in Washington among the members of the Group of Ten on a new realignment of exchange rates, with the Canadian dollar continuing to float. The agreement also provided for the widening of margins, an increase in the U.S. dollar price of gold, and the withdrawal of the U.S. import surcharge.

This agreement was an important step in allaying fears that the postwar progress towards freer international trading arrangements would be interrupted, and in establishing the basis for a gradual restoration of sustainable balance in international payments. It was therefore very welcome in Canada for we are naturally much aware of the benefits which have flowed from the progressive

freeing of international trade, and we are commensurately conscious of the costs which would follow any departure from that course.

The new exchange rates will contribute greatly to correcting the imbalance in world trade, but they must be given time to work. It is of great importance that in the pursuit of domestic objectives the mix of policies adopted by both the United States and the surplus countries should be such as to facilitate the payments adjustment that is necessary. Moreover, in the field of international monetary arrangements, various changes in practices must be devised and agreed upon by members of the International Monetary Fund, as well as provision for the eventual convertibility of the U.S. dollar. There is thus a great deal to be done before we can be confident that we have emerged from the crisis of 1971 with a well-functioning international monetary system and with stable trading relationships.

* * *

In December 1971 we added to the flow of information we provide to the public by introducing a new monthly publication, the Bank of Canada Review. In addition to an enlarged and improved presentation of statistical material previously made available each month in the Statistical Summary, the Review includes articles published on the responsibility of an Editorial Board. I hope that the Review will prove to be a useful contribution by the Bank to the fuller public discussion of matters relevant to economic policy.

* * *

I wish to record the resignation, effective December 31, 1971, of Mr. J. R. Beattie as statutory Deputy Governor of the Bank and the appointment of Mr. G. K. Bouey to succeed him.

Mr. Beattie joined the Bank on March 9, 1935—two days before it opened its doors. In the past 37 years he has made a signal contribution to the development of the institution and has set high standards of excellence in all his undertakings. The Directors of the Bank join me in this recognition of Mr. Beattie's outstanding services to the Bank.

The International Environment

The international environment in 1971 was marked by the resumption of economic expansion in the United States, a slowing in the growth of most of the other major industrial countries, some easing in price pressures as the year progressed, and a reduced rate of expansion in world trade. A dominating feature was the growing imbalance in international payments in the form of a massive deterioration in the position of the United States and very large surpluses in several other industrial countries. The accompanying pressure on exchange markets eroded confidence in the existing structure of rates; it led to large flows of speculative capital and, for a time, to a widespread abandonment of the IMF system of fixed parities. In spite of the efforts of many countries to contain these large capital flows through financial policies and direct controls, there was a massive addition to official holdings of U.S. dollars. These developments culminated in December in a broad realignment of exchange rates.

DEVELOPMENTS IN THE UNITED STATES

Economic policy in the United States was confronted with an increasingly difficult combination of circumstances during the spring and summer of 1971. By the beginning of the year fiscal and monetary policies had already moved far in an effort to stimulate recovery: the fiscal position of the United States Government had gone into substantial deficit, there had been appreciable monetary expansion during the preceding twelve months, and interest rates were well below their levels of a year earlier. Despite these developments the economy failed to resume a vigorous pace of expansion. There was, to be sure, a strong rebound in the first quarter following the settlement of a major strike in the automotive industry late in 1970, but the growth in output slowed in the second and third quarters of the year to an annual rate of 3 per cent. Although housing construction continued its strong recovery, other sectors of demand moved up rather slowly. Consumer purchases of new automobiles rose from their relatively low levels of 1970 but the rate of personal savings remained high and the mood of consumers continued to be hesitant. Business attitudes remained extremely

cautious. Plant and equipment outlays stayed close to the levels of the previous year and there was little if any general rebuilding of inventories such as had marked the early stages of previous recovery periods. Defence expenditures continued to fall. As a consequence of these developments industrial production in the summer months was still below its level of a year earlier and appreciably below its peak in the summer of 1969, and unemployment remained in the 6 per cent range that it had reached in the fourth quarter of 1970.

Concern was growing during the summer about the prospects for prices. Although there had been some indication of better price performance, this was due in the first instance to a sharp squeeze on profits and later to a pickup in productivity. Profit margins were in the course of recovering in the first half of 1971 and there was little sign of an easing in the rate of increase in average hourly earnings. Some signs of renewed acceleration in prices at the retail and wholesale levels had, in fact, appeared by mid-year.

Another disquieting aspect of the economy's performance in the first half of 1971 was the increased growth of merchandise imports at a time when exports were almost static. During 1970, when the economy was in a slight recession, imports had risen by nearly 10 per cent; during the first half of 1971, despite the disappointing pace of domestic recovery, the growth of imports accelerated to an annual rate of 28 per cent.

The economic programme introduced on August 15 contained a variety of measures designed to deal with these unsatisfactory elements in the performance of the economy. To provide additional stimulus to the economy and reduce the level of unemployment, the President recommended to Congress changes in a number of tax laws that, among other things, would provide for an investment tax credit on capital goods produced in the United States, repeal the excise tax on automobiles and advance the date of a scheduled increase in personal income tax exemptions. To check the persisting inflation of prices and costs the President invoked emergency powers to freeze virtually all prices, wages and rents for ninety days during which period a more limited and flexible system of controls would be devised. To deal with the worsening position in the balance of payments, the President announced the suspension of the convertibility of the U.S. dollar into gold and the imposition of a 10 per cent temporary surcharge on dutiable imports; concurrently the Administration revived a proposal to establish domestic international sales corporations (DISC) which would enable exporters to defer income tax on earnings from certain export sales.

The programme had a number of immediate effects. Among its domestic consequences were a very pronounced slowing in the rate of price increase and a marked tempering of inflationary expectations. In the weeks immediately following the announcement of the new programme there was a general revival of confidence in financial markets, and interest rates, which had been rising for several months, turned sharply downward.

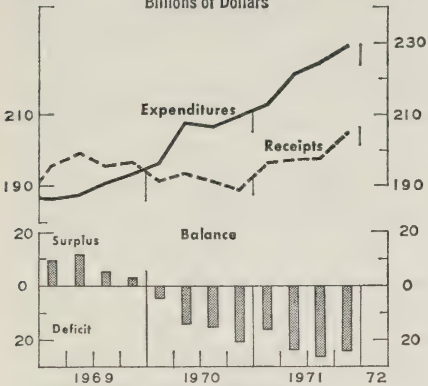
UNITED STATES

SELECTED INDICATORS

Seasonally Adjusted

FEDERAL GOVERNMENT ACCOUNTS

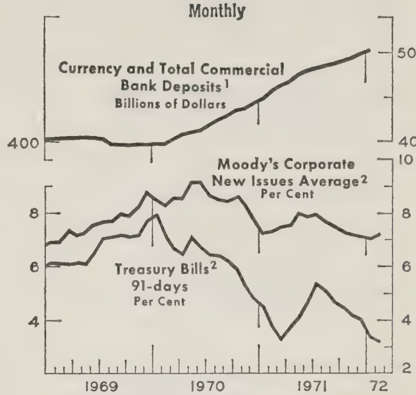
National Income Account Basis
Quarterly at Annual Rates
Billions of Dollars



Fourth quarter 1971 figures preliminary.

MONEY SUPPLY AND INTEREST RATES

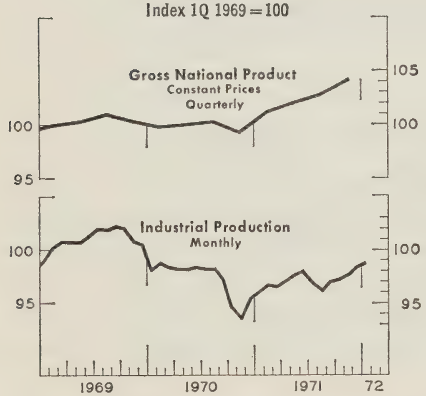
Monthly



1. Excludes U.S. Government deposits.
2. Not seasonally adjusted.

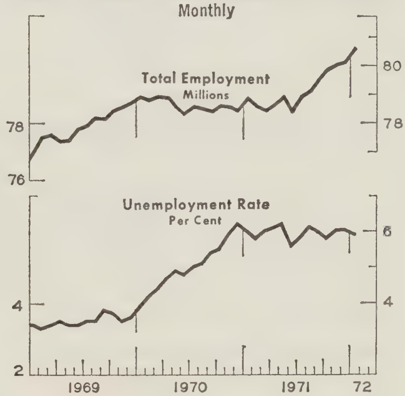
OUTPUT

Index 1Q 1969 = 100



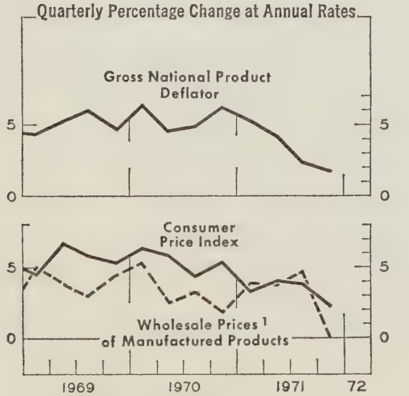
EMPLOYMENT AND UNEMPLOYMENT

Monthly



RATES OF PRICE INCREASE

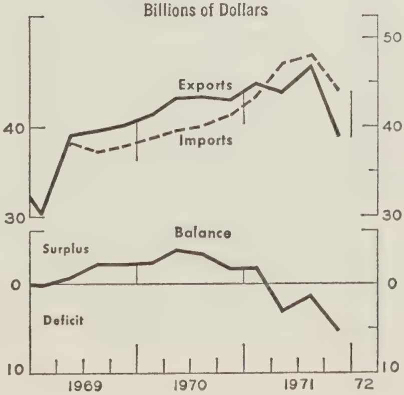
Quarterly Percentage Change at Annual Rates



1. Not seasonally adjusted.

MERCHANDISE TRADE

Quarterly at Annual Rates
Billions of Dollars



Following the end of the freeze in mid-November a fairly flexible system of price and wage controls was established. Two separate bodies—a Pay Board and a Price Commission—were set up to administer the second phase of the anti-inflationary programme, which is directed primarily at large entities and designed to operate with a minimum of administrative machinery for a period that has not been determined. These two agencies established mutually consistent standards for price and wage decisions which are intended gradually to reduce the average rate of price increase to no more than 2½ per cent per year. Between August and January the increase in the Consumer Price Index slowed to an annual rate of about 2½ per cent and the increase in the GNP deflator in the fourth quarter was at an annual rate of less than 2 per cent. Much of this improvement was, of course, due to the short-term impact of the price freeze.

Because of lags in implementation and in their eventual impact, it is too early to assess the effects of the various new fiscal measures on the pace of economic recovery. The growth in real output strengthened in the final quarter of 1971, reflecting in part a swing in inventories, but the main impact of the new fiscal measures is not likely to be felt until later in the present year.

DEVELOPMENTS IN OVERSEAS INDUSTRIAL COUNTRIES

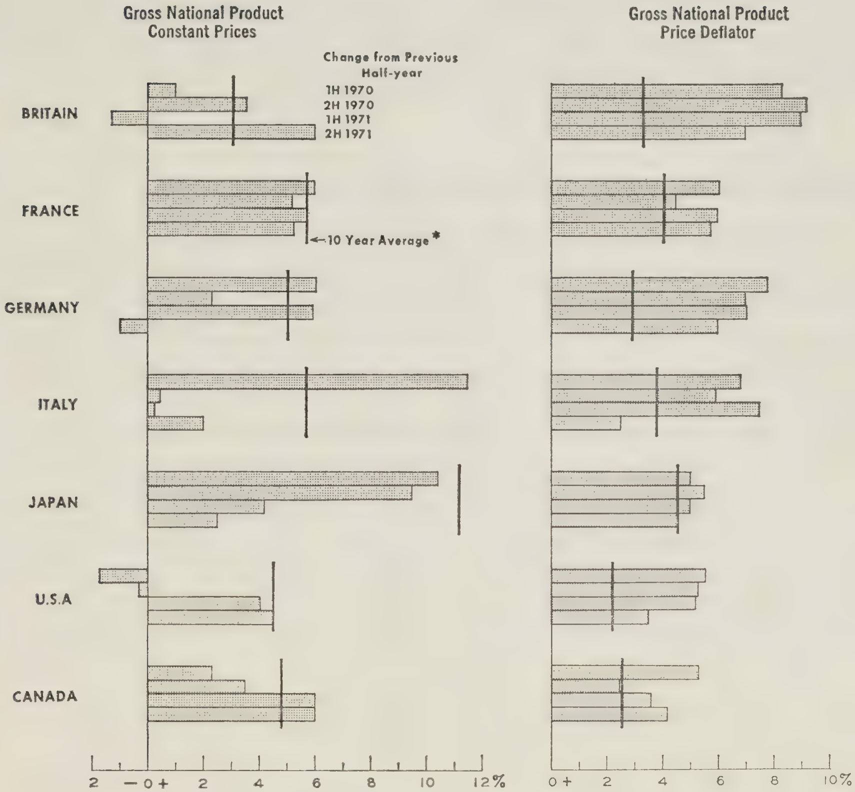
In the course of 1970 most industrial countries outside North America adopted policies to restrain demand in the face of serious inflationary pressures, and their rates of economic expansion began to slacken. Growth weakened further in 1971, notably in Japan, Italy and Germany. The two main exceptions were France, where expansion was well sustained through 1971, and Britain, where growth resumed during the second half of 1971 following a decline in output earlier in the year.

For the major European countries and Japan taken together the annual rate of increase in real GNP slowed to approximately 3 per cent by the second half of 1971, about half the average of the previous decade. By year-end the slack in these economies was substantial; in Britain, for example, unemployment reached a postwar high. The main areas of weakness among the major components of demand were business investment and inventories. The volume of exports remained relatively strong during the first half of the year and then slowed markedly during the second half, notably in Japan and Germany.

Prices in overseas industrial countries rose on average by about 6 per cent in 1971, only slightly less than in 1970. There was some evidence of improved price performance in the second half of the year in most countries, including Britain, Germany and Italy where the rates of price increase had been extremely

OUTPUT AND PRICES

Percentage Changes at Annual Rates



*Average 1958-59 to 1968-69.

high earlier. In general, however, as in North America, the response of prices to the easing of demand pressure has been slow. Some form of price restraint was used to supplement demand management in 1971 in a number of countries, including temporary price controls in several of the smaller European countries.

To date, such improvement in price performance as has occurred appears to have been due more to a squeeze on profits than to a reduction in the underlying rate of cost increase. Average hourly earnings in the major European countries and Japan rose at annual rates of between 10 per cent and 15 per cent. However, the tendency towards extraordinarily large wage demands, common in 1970 and the early part of 1971, appears to have abated somewhat by the end of the year. In some countries this may have resulted in part from the implementation of incomes policies.

The widespread slackening in the pace of economic activity has prompted a shift towards expansionary policies. Monetary policy has been eased appreciably in all of the major countries, although this action was undoubtedly motivated in part by external considerations. On the fiscal side, virtually all governments have adopted more expansionary budgets.

INTERNATIONAL TRADE AND BALANCE OF PAYMENTS

The volume of world trade increased by about 5 per cent in 1971 compared with about 9 per cent in 1970, with both manufactured goods and primary commodities showing less growth. Prices of internationally traded goods continued to rise by about 5 per cent in 1971, with the increases concentrated mainly in manufactured goods and in petroleum; on balance prices of other primary commodities seem to have changed little. The terms of trade of the developing countries that are not petroleum producers therefore appear to have deteriorated.

A very significant feature of the international trade picture in 1971 was the sharp widening in the trade gap between the United States and other large industrial countries, notably Japan. Following a rapid increase in the first half of the year, U.S. imports declined in the last quarter, mainly as a result of the disruptive effects of intermittent dock strikes. For the year as a whole they were 14 per cent higher than in 1970. Exports fell even more sharply in the

CURRENT ACCOUNT BALANCES OF OECD COUNTRIES

(billions of U.S. dollars)

	1969	1970	1971e
United States	−0.9	0.4	−3
Canada	−0.9	1.0	¼
Britain	1.1	1.5	2¼
France	−1.8	−0.2	−½
Germany	1.6	0.7	¼
Italy	2.3	0.8	1¾
Belgium and Luxembourg	0.5	0.8	½
Netherlands	–	−0.5	−½
Japan	2.1	2.0	6
Other OECD countries(1)	−0.7	−1.7	−¾
Total OECD	3.3	4.8	6¼

e: Estimate.

(1) Includes Austria, Denmark, Finland, Greece, Iceland, Ireland, Norway, Portugal, Spain, Sweden, Switzerland and Turkey.

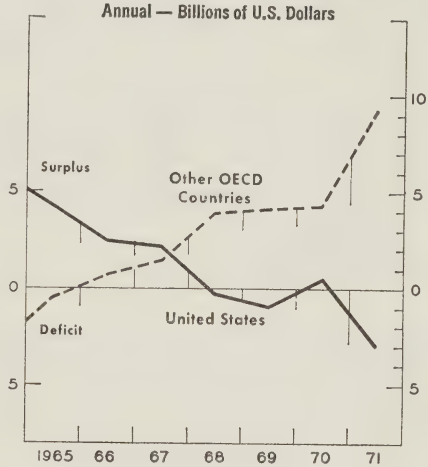
latter part of the year and for the year were only 2 per cent higher than in 1970. In most other industrial countries, growth in imports slackened while exports continued to expand strongly until late in the year. In Japan, for instance, exports were 24 per cent higher in 1971, while imports grew by only 5 per cent compared with an increase of 25 per cent in 1970.

The current account balances of a number of countries for the past three years are shown in the table on page 18. From 1970 to 1971 the current account of the United States moved from a small surplus to a deficit of $3 billion, while Japan's surplus rose by $4 billion. Germany and Canada experienced some weakening in their positions in 1971 while Italy and Britain recorded larger surpluses.

As the chart shows, the deterioration in the current account of the United States in 1971 was a continuation of the weakening trend evident since the mid-1960s. The chart vividly illustrates that the counterpart of this trend was the strengthening of current account positions of other OECD countries. The large swings in the current account balances of Japan and Britain over this period account for the greater part of the strong performance of the OECD countries other than the United States.

CURRENT ACCOUNT BALANCES OF OECD COUNTRIES

Annual — Billions of U.S. Dollars



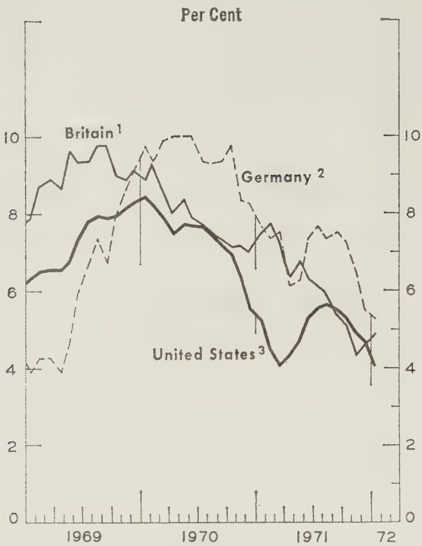
INTERNATIONAL CAPITAL FLOWS

The impact of the large and growing disequilibrium in current account positions on the international payments system was greatly exacerbated in 1971 by very large movements of capital, mainly from the United States to Japan and to the larger industrial countries of Europe.

The net outflow of long-term capital from the United States increased by some $4-$5 billion in 1971, reflecting both larger outflows of U.S. private capital for investment abroad and reduced inflows of foreign capital into the United States. This, together with the worsening in the current account balance, increased the deficit in the U.S. "basic balance" to $10 billion or more in 1971 from $3 billion in 1970.

In addition, massive flows of short-term capital developed in the course of the year, predominantly flows from the United States. Initially they were

SHORT-TERM INTEREST RATES
3-month



1. Local authority deposits.
2. Interbank deposits.
3. Finance company paper.

induced by wide differences in interest rates reflecting a divergence in the cyclical positions and financial policies of the United States and overseas industrial countries. As the world payments imbalance intensified, confidence in the existing structure of exchange rates was eroded and there were successive waves of speculative capital flows.

The first speculative surge developed in exchange markets during the second quarter; it led early in May to the floating of the currencies of Germany and the Netherlands and to the revaluation of the currencies of Switzerland and Austria. There was then a brief pause. Though interest rates in the United States were rising, capital did not return there to any great extent; instead, funds flowing out of Germany were largely diverted to other countries, especially Japan. Speculative activity resumed during the summer as attention focussed on the seriousness of the economic problems confronting the United States. The mid-August announcement of the U.S. measures put extremely strong upward pressure on the principal currencies, and most industrial countries abandoned their IMF parities. Exchange markets remained uneasy and under recurrent pressure, and large short-term outflows from the United States continued until the exchange rate realignment was announced in December.

INTERNATIONAL MONETARY DEVELOPMENTS

The large and growing imbalance in world payments in 1971 led to a massive increase in official international reserves and to a widespread change in exchange rates.

Major changes in official international reserves during 1971 are summarized in the table on the following page. The large international deficit of the United States was financed almost entirely by an increase in U.S. dollars held in the official reserves of other countries and only to a minor extent by a reduction in its holdings of reserve assets. The liabilities of the United States to foreign official agencies (mainly Treasuries and central banks) more than doubled,

rising to over $50 billion by the end of 1971. This element alone accounted for a 35 per cent increase in the official reserves of all other members of the IMF plus Switzerland. A scheduled allocation of Special Drawing Rights at the beginning of the year and increased holdings of other foreign exchange balances raised the over-all increase to about 45 per cent. The growth in reserve holdings was concentrated in a relatively few countries; the ten countries with the largest accumulations of reserves accounted for some 80 per cent of the increase in reserves outside the United States. Collectively, the reserves of these ten countries rose by about 60 per cent and the reserves of the other 110 members of the IMF rose by about 20 per cent.

OFFICIAL INTERNATIONAL RESERVES*

(in terms of billions of U.S. dollars)

	As at Dec. 31, 1970	Changes in 1971					
		Allocation of SDRs	Jan.-May	June-July	Aug.	Sept.-Dec.[e]	Total[e]
Reserve assets and official liabilities of the United States							
Assets	14.5	0.7	−1.4	−0.5	−1.2	–	−2.3
Liabilities to foreign official agencies	24.4		11.7	0.7	7.6	7.2	27.3
Official reserve transactions deficit		−0.7	13.1	1.3	8.8	7.2	29.6
Reserve assets of other countries							
Japan	4.8	0.1	2.1	1.0	4.4	2.7	10.4
Germany	13.6	0.2	5.2	−2.0	−0.3	1.5	4.6
Britain	2.8	0.3	0.4	0.3	0.9	1.7	3.6
France	5.0	0.2	0.5	0.5	1.5	0.3	2.9
Switzerland	5.1	–	−0.5	−0.2	2.1	0.1	1.6
Australia	1.7	0.1	0.7	0.2	0.1	0.5	1.6
Spain	1.8	–	0.3	0.4	0.2	0.4	1.4
Italy	5.4	0.1	0.7	–	0.4	–	1.1
Libya	1.6	–	0.7	0.1	0.1	0.2	1.0
Canada	4.7	0.1	0.1	–	0.1	0.6	0.9
Sub-total	46.5	1.1	10.2	0.4	9.6	7.8	29.1
Other IMF members	31.5	1.1	1.1	1.2	0.9	2.1	6.4
Total — other countries	78.0	2.2	11.3	1.6	10.5	9.9	35.5
of which: foreign exchange	43.9		11.7	1.3	10.4	9.7	33.1

e: Estimate.
* Official holdings of gold, SDRs, reserve positions in the IMF, and foreign exchange. Based on a gold value of U.S. $35.00 per ounce.

This dramatic increase in international reserves has frustrated for the time being the world's efforts to achieve a moderate and orderly growth over time in international liquidity, and it leaves the international monetary system with the problem of coping with the vast increase in official holdings of U.S. dollars.

Since a large part of the U.S. payments deficit was due to capital outflows motivated by expectations of changes in exchange rates it can be supposed that the exchange positions taken will sooner or later be unwound, and that the funds will flow back to the United States. Insofar as the flow-back gives rise to a surplus in the U.S. payments position on an official reserve transactions basis a reversal of the increase in foreign official holdings of U.S. dollars could be achieved. The extent to which this may happen is, however, reduced by the fact that even if things go very well the move to equilibrium in the underlying payments position of the United States can be expected to take a year or two, and there will therefore be a U.S. payments deficit to be financed during the transitional period.

The agreement in Washington on December 18 by members of the Group of Ten on changes in their exchange rates was quickly followed by changes in the exchange rates of many other countries. Since the agreement reached in the Group of Ten (the Smithsonian Agreement) included an undertaking by the U.S. Administration to propose to Congress in due course an 8.57 per cent increase in the U.S. dollar price of gold to $38 an ounce, the new exchange rate structure assumed this new U.S. dollar value for gold. A few important trading countries appreciated their currencies by more than 8.57 per cent vis-à-vis the U.S. dollar, notably Japan (16.9 per cent) and Germany (13.6 per cent). Many other countries including Britain and France did not change their exchange rates in terms of gold, thus appreciating by 8.57 per cent vis-à-vis the U.S. dollar. Several countries appreciated by less than 8.57 per cent, many others made no change and a few depreciated against the U.S. dollar. Many countries have exercised a new IMF option to establish central rates rather than par values, a central rate being a transitional alternative to a new par value. A few other countries, including Canada, continued to allow their exchange rates to float. As at the end of 1971 the Canadian dollar was floating at a level 7.9 per cent above its May 1970 IMF parity of 92.5 U.S. cents.

The realignment of currencies has significantly changed the competitive positions of individual countries vis-à-vis their trading partners. The impact on a country's competitive position is affected not only by the change, if any, in its own exchange rate but also by the magnitude of exchange rate changes made by the countries with which it trades and the proportion of its trade with each. Effective exchange rate changes may therefore differ appreciably from those in terms of the U.S. dollar. On the basis of existing trade patterns and the parities that prevailed in May 1970, the Japanese yen has on average appreciated by about 13 per cent vis-à-vis its main trading partners, and the German

mark and Swiss franc by some 4-5 per cent. For the other major European countries the effective exchange rate changes were small. On the same basis, the effective appreciation of the Canadian dollar from its May 1970 parity to its level at the end of 1971 was about 5 per cent. The effective depreciation of the U.S. dollar was about 10 per cent.

The new exchange rate structure will greatly facilitate the adjustment of the present world payments imbalance and, in particular, the strengthening of the trade balance of the United States. But the effects of exchange rate changes on trade flows take a long time to work themselves out. In present circumstances, the improvement in the U.S. trade balance will be slowed by the fact that most of the major trading partners of the United States other than Canada are experiencing relatively slow growth while demand in the United States is expected to accelerate. Thus the cyclical conjuncture is not, for the time being, helping the return of the United States to payments equilibrium.

Following a consensus among the Group of Ten in favour of wider margins the IMF established on December 19 a temporary regime whereby countries who so opt can allow their currencies to fluctuate by up to 2¼ per cent on either side of the parity or central rate for their currency. Almost half of the members, including all the major countries, have decided to avail themselves of the wider margins. In the latter part of December all the principal currencies were trading near their lower limits vis-à-vis the U.S. dollar, but by the end of February 1972 a number of them had moved well into the upper half of their ranges.

As part of the Smithsonian Agreement, the United States undertook to withdraw immediately the 10 per cent surcharge on dutiable imports that it had applied since mid-August and with it the provisions of the investment tax credit that discriminated against imports.

At the Annual Meeting of the Governors of the IMF in September and again at the December meeting of the Group of Ten there was unanimous agreement that serious international consideration should be given promptly to the longer-term reform of the international monetary system. The issues for attention include the means of ensuring stable exchange rates and the appropriate degree of flexibility in them, the role of gold, reserve currencies and Special Drawing Rights, convertibility, the volume of international liquidity, and measures for dealing with de-stabilizing movements of liquid capital. Discussions of these questions are currently being carried on in the Executive Board of the IMF.

Economic Developments in Canada

GENERAL REVIEW

The upturn in economic activity that occurred in Canada in the second half of 1970 after more than a year of relatively slow growth was followed in 1971 by continued expansion at a high rate. In spite of the adverse influence of the international monetary crisis, the continuing effects of the appreciation of the Canadian dollar, and the hesitant state of business confidence, the growth of the economy in real terms in the course of the year was at a rate somewhat in excess of its average potential for growth over the medium term.

The expansionary emphasis of demand management policies since early 1970 encouraged rising levels of spending in the economy. According to preliminary estimates, final domestic demand rose by almost 11 per cent between the second half of 1970 and the second half of 1971; this compares with an increase of less than 7 per cent over the previous year.

Not surprisingly, in view of its sharp decline from mid-1969 to mid-1970, housing was the sector that showed the strongest rebound. In response to the easing of credit conditions and an expanded programme of direct government lending, particularly for low-income accommodation, housing starts turned up sharply in mid-1970 and reached an annual record of 233 thousand units in 1971. The rate of spending on housing construction in the second half of 1971 was more than 25 per cent higher than a year earlier.

Sales of new North American cars were depressed late in 1970 and early in 1971 by the long strike in the automobile industry and did not show much renewed strength until the spring when they moved up to a high plateau. Sales of foreign-type models were also strong; they rose steadily until late in 1971 when they accounted for close to one quarter of the market compared with about one sixth two years earlier. Personal spending on other durable and semi-durable goods also rose quite sharply, especially in the first half of the year, stimulated in part by the rising number of new houses and apartments being occupied. Between the second half of 1970 and the corresponding period of 1971 total spending on durable and semi-durable goods rose by almost 14 per cent, but even so the proportion of personal disposable income saved rather than spent remained unusually high.

Outlays on goods and services by all levels of government continued to be an important sustaining element of demand, rising at about the same high rate as in the previous year—around 13 per cent.

On the other hand, business investment in machinery and equipment and non-residential construction apparently continued to be sluggish with higher prices accounting for most of the increase that occurred. Expenditures on plant and equipment normally respond with some lag to an improvement elsewhere in the economy and, while such information as is available regarding investment intentions does not suggest much immediate strength, some current indicators, such as machinery imports and construction contract awards, were rising quite rapidly by the latter part of 1971.

Business inventory accumulation also added little to demand during the year which is contrary to the usual pattern of early stages of economic recovery. There was evidence of a higher rate of accumulation in the last quarter of the year, but the level of inventories in relation to final sales, particularly in manufacturing, remained unusually low.

Contrary to the situation in 1970, when the development of a very large current account surplus provided strong support to the economy, a swing back towards deficit in the external sector acted as a strong offset to some of the increase in domestic demand in the course of 1971.* Both cyclical and special factors affecting the trade balance tended to work in this direction. In 1970 exports had been boosted by a period of "catch-up" following major strikes and by the strength of demand in overseas markets, and sales to the United States had been generally well sustained in the face of the recession in that economy. In 1971 no specially favourable factors were present: demand in Europe and Japan was weakening and access to the U.S. market in the latter part of the year was curtailed to some extent by the surcharge on dutiable imports that was in effect from mid-August to mid-December. At the same time imports, which levelled out in 1969-70 with the easing of domestic demand and actually fell as a result of the automotive strike late in 1970, were on a strongly rising trend as domestic demand expanded rapidly in 1971. Undoubtedly a further factor adversely affecting exports and favouring imports throughout the past year was the lagged effect of the appreciation of the Canadian dollar following the decision in May 1970 to permit it to float. In the event, merchandise exports were only 8½ per cent higher in the second half of 1971 than a year earlier while imports were up by 21 per cent; in volume terms exports increased by 8½ per cent and imports by 17½ per cent. There was some further deterioration in the international balance on services as well. A significant deficit on goods and services of about $½ billion was recorded in the second half of 1971 compared with an unprecedented surplus of $1¼ billion in the second half of 1970.

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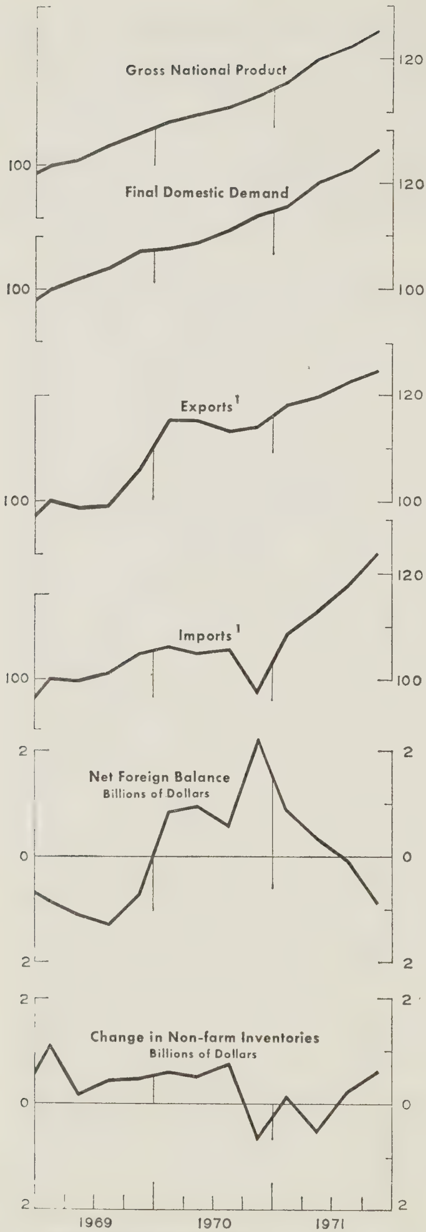
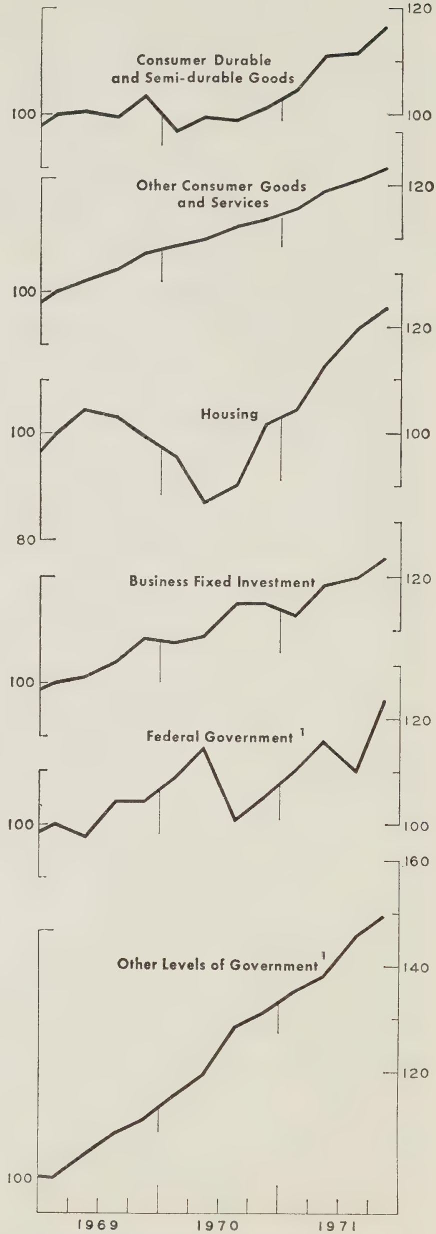
* Developments in Canada's balance of payments on current and capital accounts in 1971 will be dealt with more fully in an article to appear in the March issue of the Bank of Canada Review.

GROSS NATIONAL EXPENDITURE

Quarterly — Index 1Q 1969 = 100



Seasonally adjusted at annual rates.
1. Goods and services.



Seasonally adjusted at annual rates.
1. Goods and services.

The broad result of the changing pattern of domestic and foreign demand described above was that GNP in value terms was 9 per cent higher in calendar year 1971 compared with a gain of only 7½ per cent in 1970. Since the over-all price level rose by one half of one per cent less in 1971 than in 1970 (3½ per cent instead of 4 per cent), the gain in real GNP was 5½ per cent compared with less than 3½ per cent in the previous year. If the second half of 1971 is compared with the second half of 1970 the increases were 10 per cent for nominal GNP, 4 per cent for price and 6 per cent for real GNP.*

It is difficult, because of the paucity of information and the widely varying situations of particular industries, to appraise the effect of the rise in output in 1971 on the degree of utilization of industrial capacity. Problems of over-supply became more serious in some important industries including nickel and aluminum but others, which have had similar difficulties somewhat longer, appear to have experienced some improvement in utilization rates in the course of the year. For example, in the pulp and paper industry the sharp decline in newsprint production from late 1969 to mid-1971 was substantially reversed in the latter part of the year, although in December production again fell away. Steel production also rose strongly to a summer peak that was apparently related in part to anticipation of a possible strike—which did not in fact materialize—in the United States. Automobile output remained on a high plateau following the return to full production early in the year after the General Motors strike. On the whole, industrial production was rather slow to respond to the pickup in domestic demand and rose strongly only after the middle of 1971; over the last six months of the year industrial production increased at an annual rate of over 8 per cent. Both durable and non-durable manufacturing contributed to this recent strengthening of industrial production. Production by electric power, gas and water utilities has also risen strongly since the spring, and output of the mining industry (including petroleum) has turned up after declining in the early months of the year. Construction activity showed the earliest and sharpest rebound and rose strongly from mid-1970 in line with the trend of housebuilding. Activity in the trade and services sector increased particularly strongly through the spring and summer as sales by motor vehicle dealers and other retailers gathered strength. Agricultural output also rose very sharply from 1970 to 1971 as a result of the higher levels of grain production following the termination of the federal Government's LIFT programme. Prairie wheat acreage in 1971 was about 50 per cent higher than in 1970 and the size of the crop increased by about the same proportion.

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* These figures incorporate recent revisions to the National Accounts which have somewhat reduced the growth of real GNP in 1971, particularly in the second quarter. An alternative measure of real output, the index of real domestic product, shows a smaller increase than real GNP for the calendar year but has also risen at an average annual rate of close to 6 per cent over the past several quarters. All these figures are preliminary and subject to revision.

The recent quickening of industrial activity has not resulted in a significant reduction in the high levels of unemployment that developed in the course of 1970. In the early stages of the upturn, the gain in output appears to have been achieved to an important extent through the more efficient use of the existing work force. The 6 per cent gain in real GNP between the second half of 1970 and the same period of 1971 appears to have entailed a rise in total employment of just over 3 per cent—suggesting an improvement in output per employed worker of just under 3 per cent, which compares with the long-run average annual gain of 2-2¼ per cent in this rough measure of productivity. An above-average gain in productivity is normally to be expected in the first year of economic recovery.

The provision of new jobs in 1971 was nonetheless substantial. In the latest month for which figures are available (January 1972), the year-over-year increase in the number of persons employed was about 250,000 or 3¼ per cent. The growth of employment was particularly strong after mid-year; since June employment has increased at a seasonally adjusted annual rate of almost 4½ per cent. Most of this gain involved young persons and women; adult male employment increased at a 2 per cent annual rate over this period.

The number of persons active in the labour force grew particularly rapidly in 1971. It is the case that in the second quarter of the year the labour force participation rate was slightly lower than a year earlier and the labour force itself was only 2 per cent higher, but subsequently labour force participation increased steadily to a new high and the labour force grew at a seasonally adjusted annual rate of over 4 per cent after mid-year. Young persons and women, in particular, have been entering the job market in large numbers. Between January 1971 and January 1972 the total labour force grew by 246,000 or 3 per cent.

Because of the behaviour of the labour force and productivity described above, the unemployment rate at the beginning of 1972 was just about as high as a year earlier in spite of the increase in real output that had taken place. Indeed, according to the Labour Force Survey, the seasonally adjusted rate rose rather sharply late in the summer to a peak of 6.9 per cent. However, the sharp increase in the actual number of persons unemployed which always occurs as winter approaches was smaller than usual this past year and the seasonally adjusted rate of unemployment has declined steadily in recent months. In the latest month for which figures are available (January 1972) the seasonally adjusted unemployment rate was 6.2 per cent; this represented an actual rate of 7.7 per cent compared with 8.0 per cent a year earlier.

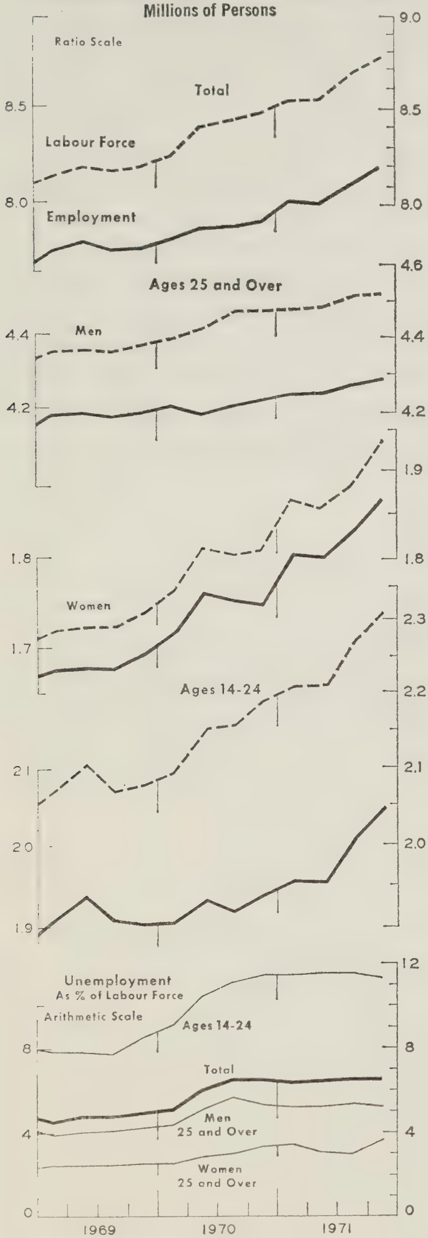
The periods of slow economic growth in 1969-70 and of more rapid expansion in 1970-71 have both been characterized by a persistent cost inflation in the face of high unemployment. The general deceleration in the rate of price increase in 1970, especially in the second half, was not sustained in 1971, partly as a result of the wearing off of the special factors that had operated on prices in

LABOUR MARKETS, PRICES AND COSTS

Quarterly

LABOUR FORCE AND EMPLOYMENT

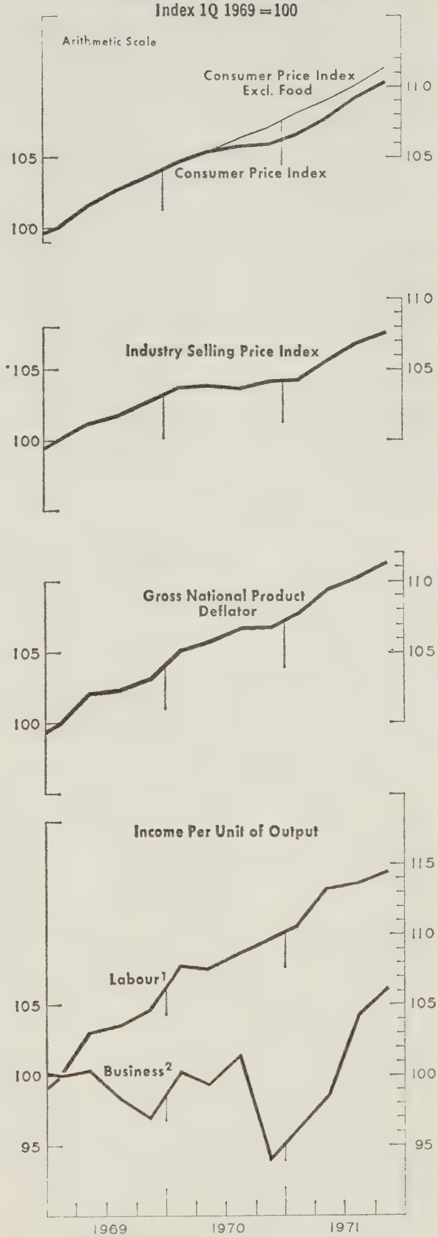
Millions of Persons



Seasonally adjusted.

PRICES AND COSTS

Index 1Q 1969 = 100



Seasonally adjusted.

1. Wages, salaries and supplementary labour income.
2. Corporate profits, non-farm unincorporated business income, corporate capital consumption allowances and the inventory valuation adjustment.

1970: these included the effect on prices of the appreciation of the exchange rate, most of which occurred in the summer of 1970; the temporary agreement on pricing decisions between industry and the Prices and Incomes Commission and the price war among retail food chains. Although it is the case that aggregate price indicators show smaller year-to-year increases in 1971 than in 1970, the increases from year-end to year-end were larger in 1971.

Consumer prices as measured by the CPI rose by about 5 per cent between the end of 1970 and the end of 1971 compared with an increase of only 1½ per cent in the previous twelve months. However, if one excludes food prices (which had fallen sharply late in 1970 only to increase by an even larger amount in the past year) consumer prices rose by just under 4 per cent in 1971 compared with less than 3½ per cent in the previous twelve months. The increase in the price index of goods other than food was somewhat greater in 1971 than in 1970 and service prices also rose more in the course of the year. In the past six months the CPI excluding food has risen at a seasonally adjusted annual rate of about 4½ per cent.

MAJOR ECONOMIC INDICATORS

(annual percentage changes)

	Average 1964-69	Year-to-year				Half year to half year*			
		1970	1971	2nd half 1970	2nd half 1971	1st half 1970	2nd half 1970	1st half 1971	2nd half 1971
GNP value	9.6	7.5	9.1	6.9	10.2	7.8	5.9	9.8	10.7
Final domestic demand	9.4	6.8	10.1	6.7	10.7	5.3	7.9	9.8	11.5
GNP volume	5.4	3.3	5.4	2.9	6.1	2.3	3.5	6.1	6.2
Real domestic product	5.4	2.4	4.5	2.5	5.5	3.2	1.8	4.9	6.0
Industrial production	5.9	2.1	3.1	1.7	5.2	5.2	−1.7	3.3	7.2
Labour force	3.3	2.6	3.1	3.4	3.2	3.6	3.2	2.3	4.1
Employment	3.3	1.3	2.5	1.6	3.2	2.0	1.2	2.5	3.8
Unemployment rate(1)	(4.3)	(5.9)	(6.4)	(6.5)	(6.5)	(5.6)	(6.5)	(6.4)	(6.5)
GNP deflator	3.9	4.1	3.4	3.9	3.9	5.3	2.4	3.6	4.1
Total CPI	3.7	3.3	2.9	2.6	3.8	4.0	1.2	2.8	4.8
CPI excluding food	3.7	3.8	3.5	3.6	3.7	3.7	3.5	3.4	3.9
Output per person employed(2)	2.0	2.0	2.8	1.3	2.8	0.2	2.3	3.4	2.3
Labour costs per unit of output(2)(3)	5.7	5.5	4.2	5.0	4.4	6.9	3.1	5.1	3.7
Business income per unit of output(2)(3)	0.4	−0.2	2.7	–	7.7	4.4	−4.2	−0.6	16.6

* Seasonally adjusted annual rates.
(1) Absolute rate, seasonally adjusted.
(2) The output measure used is GNP volume.
(3) See footnotes to chart on page 29.

The GNP deflator was almost 4 per cent higher in the second half of 1971 than a year earlier. The government and construction sectors were areas of above-average price increases. Lumber prices (and to a lesser extent those of steel) were under considerable upward pressure, and prices in both sectors were strongly influenced by the trend in pay increases. Wage negotiations in public administration and non-commercial services involved almost twice as many workers as in the previous year and were marked by large first year increases. High wage settlements also continued in the construction industry.

On the whole, wage and salary increases have shown only a limited tendency to respond to the relatively low rates of price increase that prevailed for a time or to the extended period of high unemployment. Judged by labour income per person employed, a broad and indirect measure of average compensation, money earnings increased at much the same rate in 1971 as in the previous year. Newly negotiated wage increases remained at a high level, but they did decelerate somewhat. The average increase in base rates provided by major wage settlements for all industries excluding construction declined from 8½ per cent in 1970 to 7¾ per cent in 1971; however, increases in the first year of contracts averaged 9½ per cent in 1971. The larger gain in productivity during 1971 served to some extent to restrain the rise in unit labour costs but the rate of increase in wages and salaries per unit of output was nonetheless only about 1½ per cent below the quite high rate experienced over the period 1964-69. Business income per unit of output, which had fallen sharply during 1970, recovered strongly in 1971, largely reflecting the sharp cycle in corporation profits over this period. By the second half of 1971, despite continuing problems in some major industries, total corporation profits before taxes had reached a level that exceeded their 1969 peak.

REGIONAL DEVELOPMENTS

The more vigorous pace of expansion in the economy as a whole during 1971 was reflected in the patterns of growth in all major regions of the country. The recovery was strongest in *British Columbia* which, partly as a result of labour disputes, had experienced the most marked slowing down in 1970. Although the demand for pulp and newsprint remained soft, markets for lumber strengthened with the resurgence in housing construction in both Canada and the United States. Business capital investment, particularly in mining, was substantially higher and large gains in total wages and salaries provided a strong boost to retail sales. Total employment, which had levelled off in 1970, was nearly 7 per cent higher in the second half of 1971 than a year earlier; although the labour force also expanded somewhat more rapidly, the seasonally adjusted unemployment rate averaged less than 7 per cent compared with more than 8½ per cent in the second half of 1970.

In the *Prairie provinces* better markets for grains and for other resources such as mineral fuels and potash during the past year and a half contributed to a strengthening of the economy. Employment in the region rose at a slightly faster rate but despite some slowing in labour force growth, unemployment declined only modestly. The evidence of recovery was least marked in *Manitoba* where, despite quite good gains in employment, the rate of unemployment remained around the level of the previous year. Business capital investment was apparently lower, reflecting the completion of several large projects, while production in the mining industry was adversely affected by a strike and by weaker markets for nickel. Most sectors of the *Alberta* economy strengthened in 1971 and employment rose quite strongly. Both production and prices of crude oil were higher, output of natural gas and of coal increased and business capital investment continued to expand. The improvement in the farm sector was most beneficial to the *Saskatchewan* economy. Although there was a moderate decline in both the labour force and employment, retail sales were substantially higher and there was a sharp recovery in housing starts. Prairie farm cash receipts increased, particularly in Saskatchewan. Much larger crops were harvested; wheat acreage was expanded following the sharp cutback in 1970 and acreage seeded to barley and rapeseed was increased in response to strong demand. Although wheat prices have declined this crop year, exports have been higher and the recent Government announcement of a substantially increased subsidy on domestic sales of wheat will help to maintain farm income.

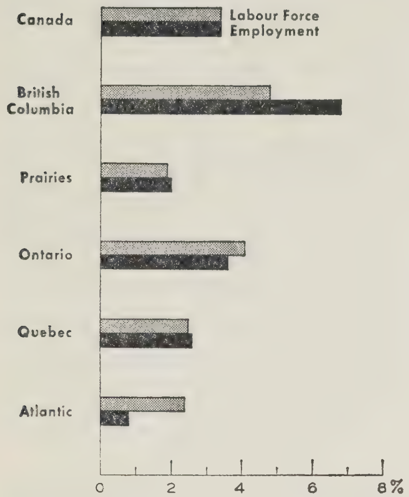
The more rapid pace of expansion in *Ontario* was, of course, closely correlated with the revival of activity in the economy as a whole. The growth of employment accelerated during 1971 and in the second half of the year employment averaged slightly more than 3½ per cent above the same period a year earlier. In spite of the increase in employment, the level of unemployment was higher as the labour force grew even more rapidly than employment. Ontario's economy benefited from the strong rise in consumer spending and the high level of housing starts across the country. Automobile production and sales, which had been adversely affected by a major strike in the last quarter of 1970, ran well ahead of a year earlier, and markets for construction materials and for domestic appliances and other consumer goods strengthened appreciably. There were areas of weakness—major industries such as machinery and pulp and newsprint experienced only a modest improvement while the mining industry had a less favourable year with a weakening in world demand and lower prices affecting nickel and copper in particular. Nevertheless, capital investment in mining apparently increased and, with higher outlays by utilities and for commercial building as well as the sharp increase in housing starts, construction activity surged ahead.

The recovery in the *Quebec* economy was also quite pronounced even though markets for a number of major industries remained relatively weak.

SELECTED INDICATORS BY REGIONS

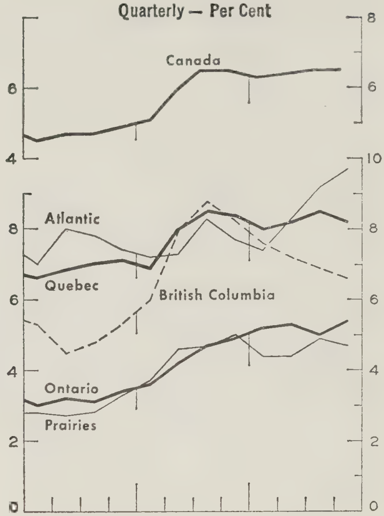
LABOUR FORCE AND EMPLOYMENT

% Increase 2H 1970 to 2H 1971



UNEMPLOYMENT RATES

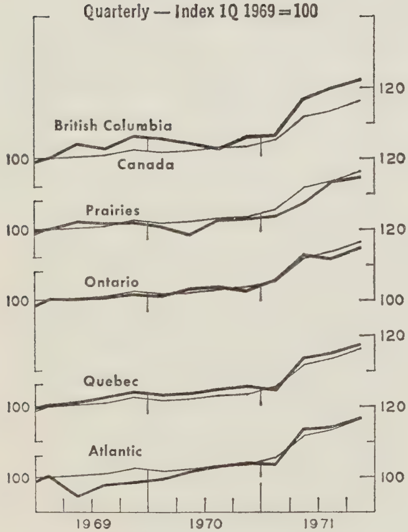
Quarterly — Per Cent



Seasonally adjusted.

RETAIL SALES

Quarterly — Index 1Q 1969 = 100

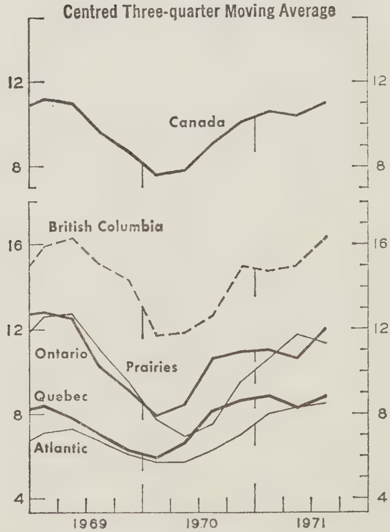


Seasonally adjusted.

HOUSING STARTS

Per Thousand Persons

Centred Three-quarter Moving Average



Seasonally adjusted at annual rates.

The main stimulating forces were a strengthening of consumer demand, increased government spending, in part related to programmes of regional expansion, and an upturn in construction activity. Although the pace of housing starts weakened in the final months of the year, spending on residential construction increased. At the same time business capital investment in the province apparently rose quite strongly, the first appreciable rise since 1966. Investment in iron ore, in nickel and copper processing facilities and in hydro power increased while government spending rose, particularly on highways and the initial stages of the new international airport near Montreal. The upturn in investment did not extend to secondary manufacturing and although production in this sector appears to have accelerated, the pattern was more mixed. The important pulp and paper industry in particular has continued to experience difficulties with slackness in markets forcing temporary shutdowns and in a few cases a permanent closing of older facilities. Activity in the aircraft, electronics and aluminum industries also contracted but it was higher in the shipbuilding and furniture industries. The renewed expansion of the Quebec economy was reflected to only a limited extent in a stronger demand for labour. Employment picked up during the year, but the gains were comparatively moderate and unemployment remained at a high level.

In the *Atlantic region* the recovery has not been as strong as in other parts of the country, in part this reflected continuing difficulties in a number of resource industries. Gains in employment were again modest and with the labour force increasing more rapidly the seasonally adjusted unemployment rate averaged around 9½ per cent in the final months of the year compared with about 8 per cent a year earlier. The strength of the recovery also varied from province to province. In *Newfoundland* capital investment apparently rose quite strongly in 1971 and provided a boost to employment. However, the upturn in employment slowed down in the second half of the year as layoffs occurred in the forest-based industries. At the same time, iron ore shipments from Labrador were lower and, although there was a strengthening in prices for fish, landings were down. Employment increased more rapidly in *New Brunswick* during 1971 than in 1970 and the economy moved ahead quite strongly. The pattern, however, was very mixed. Gains in consumer spending, in housing construction and in secondary manufacturing were a source of strength; on the other hand, business investment declined slightly from the level of the previous year, the important forest industries continued to experience difficulties and farm income declined with the drop in potato prices. In *Nova Scotia* average employment in the last half of 1971 was lower than in the same period of 1970. Although housing starts rose and there were gains in consumer spending, manufacturing activity has remained sluggish and there was apparently only a slight increase in business capital outlays. The recent discovery of gas on Sable Island holds out encouraging possibilities for the future but this has had little impact as yet on the economy.

Financial Developments in Canada

GENERAL REVIEW

The easy credit conditions that emerged in 1970 continued through 1971. Under the influence of central bank policies, funds were readily available in Canada at interest rates which were considerably lower on average than in 1970 and the amount of financing undertaken by the main borrowing sectors of the economy increased substantially.

Short-term interest rates in Canada and in the United States had fallen rapidly during 1970 and, after a brief pause around the turn of the year, the decline continued in the first quarter of 1971. The decline early in 1971 was sharper and continued for longer in Canada than in the United States. Bank Rate was reduced from 6 per cent to 5¾ per cent on February 15 and to 5¼ per cent on February 24. During the second quarter short-term interest rates began to rise again in Canada; they were already moving up in the United States. A reversal of the upward trend in the United States occurred in August when the President announced a new set of economic policies; short-term bond yields also declined in Canada. The rates on short-term money market instruments, however, continued to rise in September and October as the chartered banks competed aggressively for funds. On October 25 Bank Rate was reduced from 5¼ per cent to 4¾ per cent, and short-term market rates fell until around the end of 1971.

In 1970 long-term interest rates had come down only gradually until late in the year but in November they began to fall sharply in Canada as in the United States. The decline from then until early in 1971 was greater in Canada, and by the beginning of 1971 there had been a marked reduction or even elimination of the yield incentive for long-term capital inflows. This changed relationship of long-term interest rates in the two countries has persisted since then with relatively small variations. Beginning early in 1971 long-term interest rates began to move up again in both Canada and the United States and continued to do so until August when the announcement of the new U.S. policies reversed the trend of the markets. By the end of 1971 the levels of long-term interest rates had returned close to the low points reached in the early part of the year.

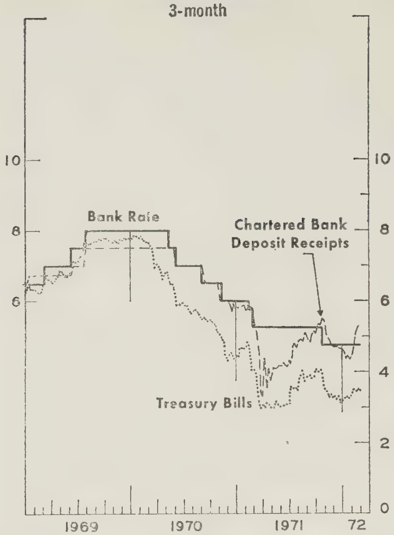
INTEREST RATES

CANADA

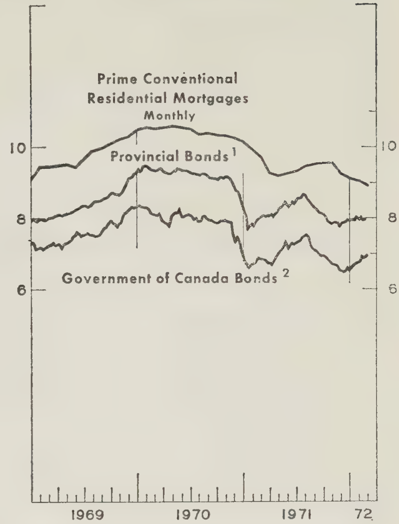
Per Cent

SHORT-TERM

3-month



LONG-TERM



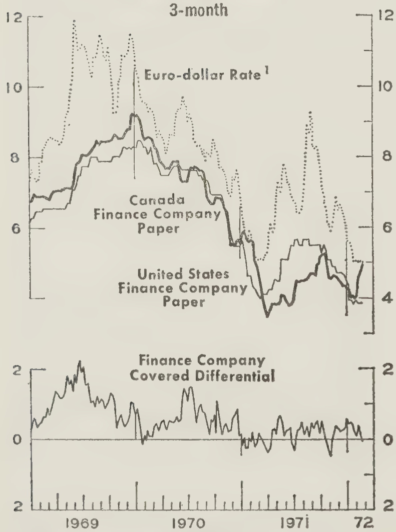
1. Wednesday average yield on 10 provincials included in the monthly series published by McLeod, Young, Weir and Co. Ltd.
2. Wednesday average yield on bonds with a maturity of 10 years or over.

INTERNATIONAL COMPARISONS

Per Cent

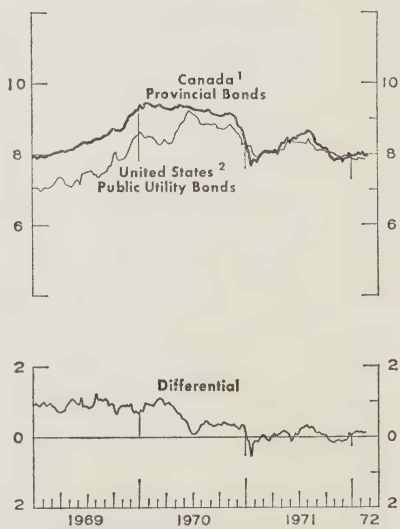
SHORT-TERM

3-month



1. Weekly average of daily figures.

LONG-TERM



Note: This chart shows the trend of yields on outstanding issues but does not provide a precise indication of yields on new security issues.

1. Wednesday average yield on the 10 provincials included in the monthly series published by McLeod, Young, Weir and Co. Ltd.
2. Wednesday average yield on the 40 public utility bonds published by Moody's Investors Services.

The total of funds borrowed by non-financial businesses, consumers, mortgagors and governments amounted to some $15 billion in 1971, an increase of more than 50 per cent from the level of 1970. Moreover, a much higher proportion of total borrowing was done in Canada in 1971 than in earlier years. The easy stance of monetary policy enabled the Canadian financial system to accommodate this very large flow of credit without any persistent upward movement of interest rates. This involved a major increase in the scale of intermediation by Canadian financial institutions. Most groups of financial institutions shared in the rapid growth, but the chartered banks accounted for the greater part of the increase. Among the banks' less liquid assets, the main categories of loans, residential mortgage holdings and other investments all increased sharply, and indeed the pace of increase accelerated during the year. Until mid-year the banks' liquid assets continued the rapid rise that began in 1970. Thereafter the increase was markedly slower but, with the rapid increase in bank loans, the banks' total major assets and the main monetary aggregates continued to rise at a fairly steady pace throughout 1971. The total of currency and chartered bank Canadian dollar deposits was 18 per cent higher in December 1971 than a year earlier while the privately held portion (i.e., excluding Government deposits) rose by 15 per cent. Broader groupings of monetary and other liquid assets are presented in a table later in this section of the Report.

SELECTED BANKING AND MONETARY STATISTICS

(average of Wednesdays — percentage increase at annual rates)

	Dec. 1970 to June 1971(1)	June 1971 to Dec. 1971(1)	Dec. 1970 to Dec. 1971
Canadian liquid assets	20.5	7.1	13.5
Less liquid assets	17.7	24.1	20.9
General loans	15.7	24.0	19.7
Residential mortgages	49.7	63.6	56.5
Total major assets(2)	20.0	18.0	19.0
Currency and Canadian dollar deposits			
Total	19.9	16.4	18.2
Privately held	16.4	13.5	14.9

(1) Based on seasonally adjusted series with the exception of residential mortgages.
(2) Includes net foreign assets.

During the first two months of 1972 bank loans continued their rapid increase while the banks' holdings of liquid assets declined and interest rates, particularly on short-term money market instruments, rose from the levels reached around year-end.

Towards the end of 1970 and in the early weeks of 1971 when the bond market was very strong and the banks were aggressive purchasers of Government of Canada securities, the management of cash reserves by the Bank of Canada was designed to control the resulting tendency for the increase in bank liquidity to accelerate. Early in February, after the sharp fall in bond yields had come to an end, the Bank of Canada resumed a policy of providing levels of cash reserves which encouraged the banks to add to their liquid assets. The two reductions in Bank Rate during February promoted the easing of credit conditions in Canada and, through their impact on levels of short-term rates of interest in the market, served to mitigate the tendency for the Canadian dollar to appreciate in exchange markets.

During the second quarter of the year the banks continued to add substantially to their liquidity. At the same time the upward movement of interest rates in the United States contributed to a tendency for the value of the Canadian dollar to decline from the peak level reached in February. In these circumstances the Bank of Canada shifted to a cash management policy that was designed to contain the growth in bank liquidity. This stance of policy was maintained until August when the new policies announced in the United States brought a reversal of the rising trend of interest rates in that country. In light of the new uncertainties raised for the Canadian economy and of renewed pressure on the exchange rate, some modification of Bank of Canada policy was appropriate. Bond yields declined although, as mentioned above, money market interest rates did rise further over the following two months or so. Bank Rate was reduced on October 25 and money market rates declined.

The management of cash reserves in the second half of 1971 as a whole was such that the lower rate of increase in bank liquidity that had emerged around mid-year persisted through the remainder of the year. The growth in loans combined with the relatively small increase in liquid assets brought the ratio of the chartered banks' Canadian liquid assets to total major assets down to 29 per cent by year-end compared with the level of about 31 per cent that prevailed through most of the first half of 1971. This measure of liquidity includes the cash and secondary reserves which the banks are required to hold, and does not take account of changes in legal requirements. The Bank of Canada reduced the required ratio of secondary reserves to Canadian dollar bank deposit liabilities from 9 per cent to 8.5 per cent effective December 1971 and to 8 per cent effective January 1972. The changes were made because the

9 per cent ratio was not regarded as being necessary for the maintenance of adequate control over bank liquidity. The record sales of Canada Savings Bonds had reduced the Government's need for borrowing through market issues. The weekly increase in outstanding treasury bills at the Thursday tender was brought to an end in November and $75 million of the special 364-day treasury bill issue maturing November 26 was paid off. This reduction in the available supply of secondary reserve assets occurred at the same time as the amount of secondary reserve assets that the banks were required to hold was rising as a result of the rapid growth of bank deposits. The changes in the required secondary reserve ratio were combined with a policy of cash reserve management by the Bank of Canada designed to reduce the banks' total holdings of liquid assets since it was not intended that the reductions in the legal requirement should lead to an increase in their "free" Canadian liquid assets, that is the amounts held in excess of reserve requirements. The result of these various policy actions, taken in conjunction with the increase in the banks' loans and other less liquid assets, was that the ratio of "free" Canadian liquid assets to total major assets was around 14 per cent in February 1972 compared with 15½ per cent in November prior to the reductions in the secondary reserve requirement. The reduction in the liquid asset holdings of the banks was accompanied by large purchases of securities by the Bank of Canada which had the effect of cushioning the upward pressure on interest rates.

In the course of 1971 the Bank of Canada at times added substantially to its holdings of foreign currency assets. These were acquired from the Exchange Fund Account to assist in the management of chartered bank cash reserves on those occasions when sole reliance on purchases of Government of Canada securities in the market was thought to be inappropriate. There was a particularly large increase in the Bank's foreign asset position in December 1971 and the early days of January 1972 which was related to the seasonal increase in the note circulation and to the increase in required cash reserves. In subsequent weeks the seasonal decline in the note circulation together with acquisitions of securities by the Bank were accompanied by a significant reduction in the Bank's holdings of foreign currency assets through resale to the Exchange Fund Account.

Changes in the Bank of Canada's monthly holdings of Government of Canada securities in 1971 are summarized in Appendix Table II. The number of days on which advances to chartered banks and on which security holdings under purchase and resale agreements were outstanding, and the average daily amounts outstanding, are indicated in a footnote to that table.

FINANCING BY MAJOR BORROWING SECTORS

The following review summarizes the financing undertaken during 1971 by the major non-financial borrowers in the economy.

NON-FINANCIAL BUSINESS. Estimates of business borrowing in 1971 show a substantial increase over the previous year. At the same time a marked recovery in profits increased the amount of internally generated funds available to business. With inventories and business fixed investment increasing only modestly, the business sector's holdings of financial assets must have risen appreciably.

The largest part of the net increase in business borrowing from $2.9 billion in 1970 to $5.0 billion in 1971 occurred in loans from financial institutions, mainly the banks, although the sales finance companies reversed the decline in their business lending that had occurred in 1970. Total financing by business in securities markets remained at about the same level as in 1970. Bond issues in Canadian currency were higher and there was a marked shift away

MAJOR SOURCES OF FUNDS OBTAINED BY NON-FINANCIAL BUSINESS

(millions of dollars)

	1969	1970	1971
Net new issues of:			
Bonds			
Canadian dollar	377	995	1,361
Foreign currency	361	355	127
Stocks			
Canadian dollar	604	281	271
Foreign currency	192	19	10
Commercial paper	306	181	278
Bankers' acceptances	58	221	8
Sub-total	1,898	2,052	2,055
Increases in loans:			
Chartered banks(1)	1,307	439	2,036
Sales finance companies	181	− 174	274e
Industrial Development Bank	54	69	54
Sub-total	1,542	334	2,364e
Net direct investment from abroad	350	490	590
Total	3,790	2,876	5,009e

e: Estimate.

(1) Total business loans excluding provincially-guaranteed loans to utilities, plus foreign currency loans to residents.

from foreign currency issues. New equity issues remained near the same level as in 1970 and well below that of 1969. Borrowing through the issue of short-term securities was lower than in 1970; there was a sizeable increase in the amount of commercial paper outstanding but bankers' acceptances rose by only $8 million compared with $221 million in 1970.

A large part of the net new borrowing in securities markets occurred in the first half of the year and was encouraged by the marked strengthening of the bond market that occurred in the latter part of 1970 and the early months of 1971. Market borrowing picked up once again in the final months of the year. Bank lending to business was concentrated in the second half of the year when business loans increased at a seasonally adjusted annual rate of 38 per cent.

CONSUMER SECTOR. The strong growth in consumer expenditures in 1971, especially on durable goods, was reflected in a substantial increase in the amount of consumer credit outstanding, particularly after May. The increase over the year was 12 per cent and represented a net flow of funds to consumer borrowers almost twice as large as in 1970.

The growth of chartered bank personal loans accounted for most of the increase in consumer credit, although loans from credit unions and caisses populaires also increased rapidly. There was a further shift in consumer borrowing away from sales finance and consumer loan companies and, as is typical in periods of credit ease, the rate of growth in life insurance company policy loans declined.

MAJOR SOURCES OF INCREASE IN CONSUMER CREDIT OUTSTANDING

(millions of dollars)

	1969	1970	1971
Chartered banks[1] (unsecured personal loans)	481	506	1,114
Sales finance and consumer loan companies	408	− 80	− 121
Credit unions and caisses populaires	154	92	207[e]
Life insurance companies (policy loans)	107	99	25[e]
Other[2]	116	53	87[e]
Total	1,266	670	1,312[e]

e: Estimate.

(1) For comparability the relevant loans of the bank operating under the Quebec Savings Bank Act which became a chartered bank in November 1969 are included with chartered bank loans prior to that time.

(2) Includes credit extended by the bank operating under the Quebec Savings Bank Act, department stores, furniture and appliance dealers and through the use of oil company credit cards.

MORTGAGE BORROWING. Housing starts were at a record level in 1971 and expenditures on residential construction increased by 23 per cent while non-residential construction expenditures rose by 10 per cent, only slightly less than in 1970. The mortgage market was, therefore, called upon to provide a substantially larger amount of funds in 1971. The record amount of mortgage financing during the year was accomplished at interest rates below those prevailing in the previous year.

The chartered banks accounted for most of the increase in the net flow of funds into this sector. The banks' mortgage loans outstanding, including net acquisitions from mortgage affiliates, rose by $851 million compared with $133 million in 1970. Credit unions and caisses populaires also expanded their mortgage lending substantially. There was a small increase in the net flow of mortgage funds from trust and mortgage loan companies while net lending by life insurance companies remained at a relatively low level. However, both of these groups of companies increased their loan approvals substantially in 1971.

Mortgage lending by Central Mortgage and Housing Corporation was also larger in 1971. The financing of these loans is included with the federal Government's financing requirements.

INCREASE IN THE MORTGAGE HOLDINGS OF THE MAJOR PRIVATE FINANCIAL INSTITUTIONS

(millions of dollars)

	1969	1970	1971
Life insurance companies	299	148	132e
Trust and mortgage loan companies	810	869	918e
Credit unions and caisses populaires(1)	100	115	290e
Pension funds	97	155	144e
Other financial institutions excluding chartered banks(2)	38	41	20e
Sub-total	1,344	1,328	1,504e
Chartered banks(3)(4)	264	133	851
Total	1,608	1,461	2,355e
Increase in the mortgage holdings of CMHC	392	501	619e

e: Estimate.

(1) Includes local and central credit unions and caisses populaires.

(2) Includes the bank operating under the Quebec Savings Bank Act and mutual and fraternal benefit societies.

(3) Includes net purchases or sales of mortgages from chartered banks' mortgage affiliates.

(4) For comparability the mortgage loans of the bank operating under the Quebec Savings Bank Act which became a chartered bank in November 1969 are included with chartered bank loans prior to that time.

GOVERNMENT FINANCING. The federal Government's financing requirements increased from $1.9 billion in 1970 to $2.2 billion in 1971. Its revenue-expenditure balance (on a national accounts basis) moved further into deficit and lending activity, including the very substantial financing of loans through CMHC, was higher. On the other hand, the amounts required to finance additions to official foreign exchange reserves fell from the extraordinarily high level of $1,566 million in 1970 to $683 million in 1971. The Government also added to its cash balances by $823 million during 1971.

Canada Savings Bonds were the major source of borrowed funds; the amount outstanding increased by $2.5 billion, principally as a result of the very successful campaign in the autumn of 1971. The increase in treasury bills and marketable bonds held outside Government accounts amounted to $466 million, well down from $1.3 billion in 1970.

GOVERNMENT OF CANADA FINANCING REQUIREMENTS

(millions of dollars)

	1969	1970	1971
1. Budgetary surplus (—) or deficit	−605	165	688
Adjustments to national accounts basis(1)	−168	− 153	− 338
2. National accounts basis surplus (—) or deficit	−773	12	350
3. Increase in major loans and advances to:			
Central Mortgage and Housing Corporation	468	552	711
Provincial governments	67	32	111
Export Development Corporation	35	51	112
Other(1)	284	340	373
Sub-total	854	975	1,307
4. Canadian dollars required to finance increase in Government's foreign currency assets (or reduction in liabilities)(1)	6	1,566	683
5. Funds required for net increase in other assets or reduction in other liabilities(1)	−484	− 646	− 178
6. Total Canadian dollar financing requirements (sum of items 2, 3, 4 and 5)	−397	1,907	2,162
Increase in Canadian dollar cash balances	675	85	823
Total borrowing	278	1,992	2,985

(1) A more detailed presentation of the Government's financial accounts together with a reconciliation between the national accounts and budgetary position are shown in Appendix Table III.

The combined cash requirements of the provinces and municipalities and their enterprises totalled \$3.1 billion in 1971 compared with \$2.6 billion in the previous year. This growth was related to an increase in the aggregate income-expenditure deficit of the provinces and municipalities from \$93 million in 1970 to \$163 million in 1971 and a rise of over \$200 million in net capital outlays of government enterprises to a level of \$1.8 billion. In addition, there was apparently some expansion in provincial lending programmes. The main source of the larger amounts of funds required was the domestic bond market where net new issues were \$1.3 billion. In addition, the acquisition of provincial and municipal securities by Canada and Quebec Pension Plan funds provided \$1.1 billion, slightly more than in 1970. Provincial and municipal security issues in foreign currency amounted to \$279 million, down from 1970.

MAJOR SOURCES OF FINANCING: FEDERAL, PROVINCIAL AND MUNICIPAL GOVERNMENTS AND THEIR ENTERPRISES*

(millions of dollars)

	1969	1970	1971
Government of Canada			
Increase in securities outside Gov't accounts:			
Treasury bills	67	720	190
Canadian dollar market bonds	− 113	558	276
Canada Savings Bonds	324	714	2,519
Total(1)	278	1,992	2,985
Provincial and Municipal Governments			
Increase in outstanding Canadian dollar bonds:			
Purchased by Canada and Quebec Pension Plan funds	1,005	1,063	1,089e
Other Canadian dollar bonds	109	964	1,271
Increase in loans from:			
Chartered banks	54	− 36	− 37
Government of Canada (including CMHC)	194	249	368
Increase in provincial treasury bills and short-term paper outstanding	− 20e	10e	130e
Increase in foreign currency issues outstanding	1,020	365	279
Total provincial and municipal borrowing(2)	2,362	2,615	3,100e

e: Estimate.

* To obtain a total of combined federal, provincial and municipal financing without double counting, loans from the Government of Canada to the provinces and municipalities shown above would have to be eliminated, as well as changes in provincial and municipal holdings of Government of Canada securities.

(1) Excluding net new foreign currency issues of the Government of Canada which amounted to \$14 million in 1969, −\$121 million in 1970 and −\$2 million in 1971.

(2) To the extent that it has not been possible to identify purchases by provincial government accounts of provincial or municipal securities, the total of provincial and municipal financing is overstated.

THE STRUCTURE OF FINANCING IN 1971

The various credit flows discussed in the preceding pages are summarized below. The total amount borrowed by the non-financial sectors of the economy is estimated to have risen from about $9½ billion in both 1969 and 1970 to $14.8 billion in 1971, an increase of more than 50 per cent. A rapid increase in borrowing is not untypical of an economy in an upswing. The high level of mortgage and consumer borrowing reflects the degree to which residential construction and consumer expenditure contributed to the increase in total spending in the economy. The relationship between borrowing and spending by the business sector has not been so close. The amount of business borrowing cannot be explained entirely by investment in inventories and fixed assets in 1971 and it seems clear that there has been a substantial increase in business holdings of financial assets.

FUNDS RAISED BY MAJOR NON-FINANCIAL BORROWERS

(millions of dollars)

	1969	1970	1971
Non-financial business	3,790	2,876	5,009e
Consumers	1,266	670	1,312e
Mortgage borrowers	1,608	1,461	2,355e
Provinces and municipalities	2,362	2,615	3,100e
Sub-total	9,026	7,622	11,776e
Federal Government	278	1,992	2,985
Total	9,304	9,614	14,761e

e: Estimate.

The table on the following page shows the total financing of the major non-financial borrowers classified by types of instruments issued and by major sources of funds. It illustrates the important changes that have occurred in the structure of financing. Financing through the net issue of securities payable in foreign currencies, which had amounted to $1.6 billion or 17 per cent of total borrowing in 1969, declined to $761 million in 1970 and to $372 million in 1971 when it accounted for less than 3 per cent of total borrowing. Although net new marketable security issues in Canadian dollars by non-financial borrowers declined slightly in 1971 to $3.8 billion, they remained at a very high level. In 1970 these net new issues had risen to $3.9 billion from $1.4 billion in 1969. The net issue of Canada Savings Bonds, which is shown separately from net new marketable securities in the table, amounted to $2.5 billion in 1971 compared with $714 million in 1970.

TYPES AND SOURCES OF FINANCING: MAJOR NON-FINANCIAL BORROWERS

(millions of dollars)

Types of Instrument	1969	1970	1971
Mortgage and other loans from financial institutions to non-financial borrowers			
Banks(1)	2,106	1,042	3,964
Trust and mortgage loan companies	810	869	918e
Sales finance and consumer loan companies	589	— 254	153e
Credit unions and caisses populaires	254	207	497e
Life insurance companies	406	247	157e
Other(2)	195	263	221e
Sub-total	4,360	2,374	5,910e
Net new Canadian dollar marketable issues of non-financial borrowers including governments(3).			
Treasury bills and short-term paper	381	1,110	650
Bonds	373	2,517	2,908
Stocks	604	281	271
Sub-total	1,358	3,908	3,829
Net new foreign currency issues of non-financial borrowers including governments			
Short-term paper	30	22	— 44
Bonds(4)	1,381	720	406
Stocks	192	19	10
Sub-total	1,603	761	372
Canada Savings Bonds	324	714	2,519
Provincial and municipal securities purchased by Canada and Quebec Pension Plan funds	1,005	1,063	1,089e
Net direct investment from abroad	350	490	590
All other(5)	304	304	452e
Total	9,304	9,614	14,761e
Sources of Funds			
Domestic financial institutions			
Loans	4,360	2,374	5,910e
Acquisitions of securities(6)	872	3,510	4,378e
Direct borrowing from the non-financial public	1,772	2,469	3,615e
Borrowing from non-residents(7)	2,300	1,261	858
Total	9,304	9,614	14,761e

e: Estimate.

(1) For comparability the loans of the bank operating under the Quebec Savings Bank Act which became a chartered bank in November 1969 are included with chartered bank loans prior to that time.

(2) Includes the bank operating under the Quebec Savings Bank Act, mutual and fraternal benefit societies, pension funds and the Industrial Development Bank.

(3) Excludes marketable securities acquired by Quebec Pension Plan funds, which are included below with non-marketable securities issued to the Canada Pension Plan; includes provincial savings bonds.

(4) Excludes net new foreign currency issues of the Government of Canada, which amounted to $14 million in 1969, – $121 million in 1970 and – $2 million in 1971.

(5) Federal Government lending to provinces and municipalities and consumer credit provided by some retailers including department stores and oil companies.

(6) Includes acquisitions of Government of Canada securities by the Bank of Canada.

(7) Includes both foreign currency and Canadian dollar securities acquired by non-residents as well as net direct investment from abroad.

As the figures at the bottom of the table on page 46 show, domestic financial institutions acquired a higher volume of marketable securities but it was the increase in their lending activity that accounted for the greater part of the growth in total borrowing during 1971. Loans from financial institutions to the major borrowers rose from $2.4 billion in 1970 to $5.9 billion in 1971, with the banks accounting for most of the increase. In aggregate, loans plus net security purchases by financial institutions increased in 1971 to 70 per cent of the total borrowing shown in the table, from 61 per cent in 1970.

The major role of the banks and other financial institutions in supplying the substantial increase in financing undertaken in 1971 without a tightening of credit conditions was facilitated by monetary policy. From the early part of 1970 through to mid-1971 the central bank permitted a substantial growth to occur in chartered bank liquid assets. The impact of this policy on bank liquidity and

MAJOR ASSETS OF SELECTED FINANCIAL INSTITUTIONS

	Millions of dollars Dec. 1971	Percentage Increase(1)			
		Average 1966-68	1969	1970	1971
Deposit-taking institutions					
Chartered banks(2)(3)	35,893	11.6	5.0	9.3	19.0
Quebec savings bank(3)	611	9.6	6.5	7.5	12.5
Trust and mortgage loan companies	10,929e	10.2	13.2	13.8	13.2e
Credit unions and caisses populaires(4)	5,263e	13.2	9.5	11.5	21.9e
Sub-total	52,696e	11.5	7.0	10.5	18.0e
Contractual savings institutions					
Life insurance companies	15,535e	6.3	4.9	4.2	5.8e
Pension funds	12,203e	10.9	11.8	10.7	11.2e
Sub-total	27,738e	8.0	7.7	6.9	8.1e
Other					
Sales finance and consumer loan companies	5,323e	6.0	14.5	– 2.7	3.6e
Mutual and closed-end funds(5)	3,842e	15.9	– 5.3	–10.5	5.8e
Total	89,599e	10.1	7.0	7.2	13.3e

e: Estimate.

(1) Percentage increase over previous year-end.

(2) Major Canadian dollar assets plus net foreign currency assets; average of Wednesdays.

(3) For comparability the assets of the bank operating under the Quebec Savings Bank Act which became a chartered bank in November 1969 are included with chartered bank assets prior to that time.

(4) The average annual percentage increase shown for 1966-68 relates to local credit unions and caisses populaires only. Thereafter the data are based on consolidated estimates for local and central credit unions and caisses populaires.

(5) The major assets of the mutual and closed-end funds are shown at market value.

on the level of short-term money market rates encouraged both the banks and other intermediaries to expand their lending activities. The chartered banks' total major assets grew by 19 per cent in 1971 compared with 9 per cent in 1970. Only the credit unions and caisses populaires appear to have grown as rapidly although deposit-taking institutions generally grew faster than other financial institutions. The assets of institutions specializing in long-term contractual savings agreements—life insurance companies and pension funds—grew by 8 per cent in aggregate. Sales finance and consumer loan companies showed a modest increase in assets following an absolute decline in 1970 when they were adversely affected by the automobile strike in the fourth quarter. The market value of the assets of mutual and closed-end funds increased by 6 per cent in 1971, mainly reflecting the higher level of stock prices at the end of the year.

CHARTERED BANKS. The chartered banking system grew at a fairly steady rate during 1971 but, as already noted, there was a substantial change in the composition of the increase in the banks' assets beginning about mid-year. A slowdown in the growth of liquid assets in the second half of the year was largely offset by a more rapid increase in less liquid assets and the total major assets of the banks grew at a seasonally adjusted annual rate of 18 per cent in the second half compared with 20 per cent in the first half of the year.

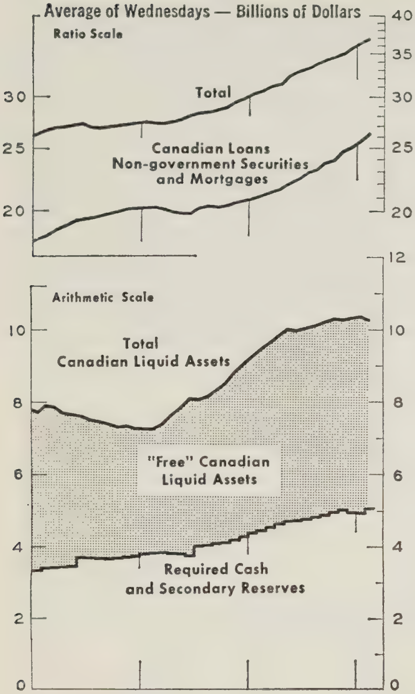
Over the year as a whole, the less liquid assets of the chartered banks increased by 21 per cent. The most rapidly growing component of this category was mortgage loans. Mortgage lending by the banks has risen substantially since the Bank Act revision of 1967 and it rose particularly rapidly last year. Both unsecured personal loans and business loans grew by about 24 per cent in 1971. Large term loans to businesses appear to have increased even more rapidly and the proportion of business loans accounted for by term lending was substantially larger than in previous years.

Chartered bank business loan authorizations under lines of credit of $100,000 and over, which began to increase rapidly about mid-1970, rose by 34 per cent in 1971. Until late in 1971 the growth in authorizations of $100,000 and over was more rapid than the increase in loans outstanding under these lines of credit; the unused portion of these lines rose from 46 per cent in March 1970 to 53 per cent at the end of 1971. The growth of authorized lines of credit has been particularly strong in the larger accounts.

Chartered bank holdings of provincial, municipal and corporate securities rose by 42 per cent in 1971. The designation of all these securities as "less liquid" assets is somewhat imprecise, particularly since they include some short-term paper, and no clear-cut line can be drawn between those kinds of assets which are liquid and those which are not. In 1971 the banks appear to have added to their combined holdings of commercial and finance company paper

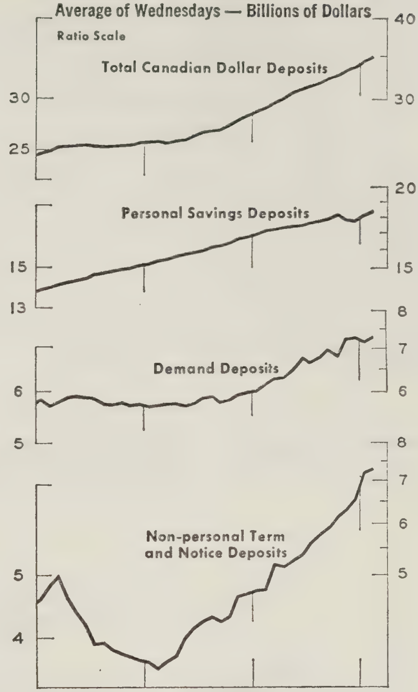
CHARTERED BANK ASSETS AND LIABILITIES

ASSETS



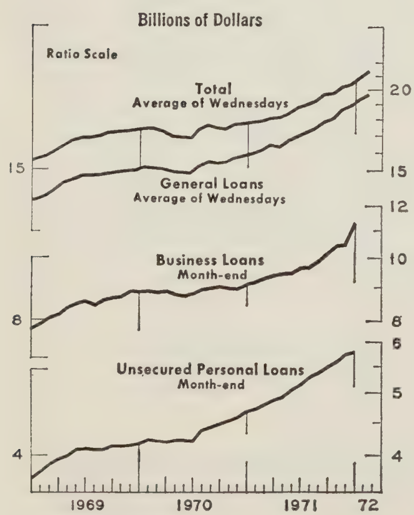
Seasonally adjusted.
February 1972, preliminary figures.

CANADIAN DOLLAR DEPOSITS



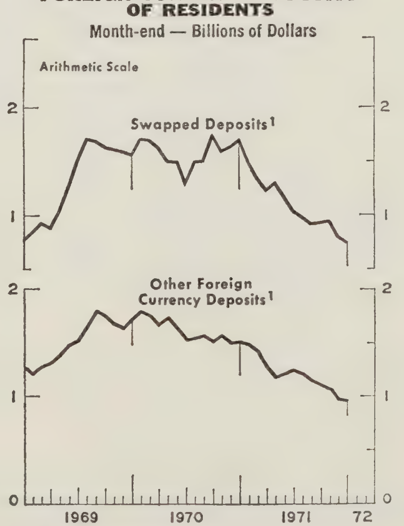
Seasonally adjusted.
February 1972, preliminary figures.

LOANS



Seasonally adjusted.
February 1972, preliminary figures.

FOREIGN CURRENCY DEPOSITS OF RESIDENTS



1. Not seasonally adjusted.

and bankers' acceptances, none of which are classified as liquid assets in the above analysis.

On the liability side of the banks' balance sheet, demand deposits increased by 21 per cent in 1971. With the rapid growth of expenditure in the economy the need for transactions balances increased, and the decline in short-term interest rates reduced the sacrifice involved in holding liquidity in this non-interest-bearing form. The growth in personal savings deposits continued for most of the year at about the 10 per cent annual rate recorded in the previous two years but the very large sale of Canada Savings Bonds in the fourth quarter resulted in a larger than usual decline in personal savings deposits at that time, and for the year as a whole the increase was 6 per cent. The level of Government of Canada deposits was, of course, also affected by the Canada Savings Bond campaign and averaged almost $2.6 billion in December.

CHARTERED BANK MAJOR ASSETS AND LIABILITIES

(average of Wednesdays)

	Millions of dollars Dec. 1971	Percentage increase		Seasonally adjusted at annual rates	
		1970(1)	1971(1)	Dec. 1970 to June 1971	June 1971 to Dec. 1971
Total major assets(2)	35,893	9.3	19.0	20.0	18.0
Canadian liquid assets	10,418	24.9	13.5	20.5	7.1
Less liquid Canadian assets	25,249	2.8	20.9	17.7	24.1
including: general loans	18,839	5.3	19.7	15.7	24.0
(business loans)(3)	(11,068)	(3.2)	(24.4)	(12.3)	(37.7)
(unsecured personal loans)(3)	(5,777)	(12.2)	(23.9)	(21.9)	(26.0)
residential mortgages(4)	2,268	10.5	56.5	49.7	63.6
provincial, municipal and corporate securities(4)	2,270	9.3	42.3	34.4	50.7
Total Canadian dollar deposits (less float)	33,994	10.5	18.9	20.8	17.1
Demand deposits (less float)	7,519	4.9	21.0	26.1	16.0
Personal savings deposits	17,530	10.6	6.4	9.4	3.6
Non-personal term and notice deposits	6,375	26.2	39.5	30.6	49.4
Government of Canada deposits(4)	2,571	− 7.4	93.3	11.0	236.8
Swapped deposits(3)(4)	732	8.9	−56.7	−61.8	− 50.8
Other foreign currency deposits of residents(3)(4)	965	−12.4	−35.7	−32.4	− 38.7

(1) Percentage increase over previous year-end.

(2) Includes net foreign assets amounting to — $82 million in December 1969; $89 million in December 1970; $221 million in June 1971 and $226 million in December 1971.

(3) Month-end figures.

(4) Half-yearly percentage increase not seasonally adjusted.

Non-personal term and notice deposits were up by almost 40 per cent in 1971 while foreign currency deposits of residents, including swapped deposits, declined by 47 per cent. Much of the gain in non-personal term and notice deposits appeared to involve the substitution of these deposits for foreign currency deposits.

TRUST AND MORTGAGE LOAN COMPANIES. The outstanding mortgage loans of these companies increased by 14 per cent in 1971. The strong growth in mortgage lending in recent years has raised the proportion of mortgages to total major assets and at the end of 1971 this proportion was almost 70 per cent. In common with a number of other financial institutions the trust and mortgage loan companies showed a substantial percentage growth in holdings of corporate, provincial and municipal bonds in 1971.

Guaranteed investment certificates, debentures and other term deposits continued to be the main source of funds for trust and mortgage loan companies in 1971 although the rate of growth of their other deposits matched that of their term deposits for the first time since 1964.

TRUST AND MORTGAGE LOAN COMPANIES MAJOR ASSETS AND LIABILITIES

	Millions of dollars Dec. 1971e	Percentage increase(1) Annual average 1966-68	1969	1970	1971e
Total major assets	10,929	10.2	13.2	13.8	13.2
Cash and short-term investments(2)	1,416	19.7	10.7	32.1	10.3
Bonds	1,703	9.0	4.7	− 1.0	14.0
Government of Canada	690	8.6	12.1	− 7.4	5.5
Provincial and municipal	571	7.5	− 4.1	6.6	21.5
Corporate	442	12.0	3.1	2.2	19.5
Mortgage loans and sales agreements	7,614	9.2	16.3	15.1	13.7
Preferred and common stocks	196	9.1	6.5	− 1.1	10.1
Total major liabilities	9,919	11.1	13.5	14.8	14.0
Guaranteed investment certificates, debentures and other term deposits	7,694	13.9	16.7	16.3	14.0
Other deposits	2,225	4.2	3.9	9.8	13.9

e: Estimate.

(1) Percentage increase over previous year-end.

(2) Short-term investments include: Government of Canada treasury bills, term deposits in chartered banks and trust and loan companies, short-term notes of sales finance companies, commercial paper, collateral loans and assets denominated in foreign currency.

CREDIT UNIONS AND CAISSES POPULAIRES. The 22 per cent growth in the major assets of credit unions and caisses populaires in 1971 allowed these institutions to increase their mortgage lending substantially without increasing the proportion of their funds allocated to mortgages. Some credit unions and caisses populaires became approved lenders under the National Housing Act in 1971. Consumer lending was also large in absolute terms compared with previous years although it did not grow as rapidly as other major investments.

CREDIT UNIONS AND CAISSES POPULAIRES
SELECTED ASSETS AND LIABILITIES*

	Millions of dollars Dec. 1971e	Percentage increase(1)		
		1969	1970	1971e
Total major assets	5,263	9.5	11.5	21.9
Cash, demand and term deposits	361	9.2	40.7	13.5
Government of Canada, provincial and municipal bonds	972	11.6	15.5	34.3
Consumer loans	1,700	12.3	6.6	13.9
Other loans	317	– 2.2	11.7	27.8
Mortgages	1,647	8.8	9.3	21.4
Other investments(2)	266	2.6	14.7	48.6
Total major liabilities	5,082	9.4	12.8	21.7
Deposits	3,682	16.9	18.3	29.5
Share capital	1,400	– 2.3	2.6	5.0

e: Estimate.

* Consolidated estimates for local and central credit unions and caisses populaires based on quarterly data published by Statistics Canada.

(1) Percentage increase over previous year-end.

(2) Includes investments in religious institutions, hospitals, and other investments not shown elsewhere.

LIFE INSURANCE COMPANIES. The growth of life insurance companies, the largest of the contractual savings institutions, is not influenced by variations in credit conditions to the same extent as deposit-taking institutions. Nonetheless, their ability to attract funds apparently improved in 1971 compared with the previous two years.

As already noted, the rate of increase in their mortgage loans outstanding declined further in 1971. These companies have been undertaking a shift in the composition of their asset portfolios, stressing acquisitions of stocks and real estate and, more recently, corporate bonds. Since 1968 their holdings of stocks and real estate have increased from 7½ per cent to 13 per cent of total major assets at the end of 1971.

LIFE INSURANCE COMPANIES: ASSETS HELD IN CANADA*

	Millions of dollars Dec. 1971e	Percentage Increase(1) Annual average 1966-68	1969	1970	1971e
Total major assets	15,535	6.3	4.9	4.2	5.8
Government of Canada securities	513	− 5.9	1.1	13.8	2.0
Provincial and municipal securities	1,853	1.0	− 2.9	0.5	4.1
Corporate securities	3,277	6.0	− 2.2	6.7	10.4
Mortgage loans	6,720	7.2	4.9	2.3	2.0
Real estate	853	11.4	19.7	11.8	19.6
Preferred and common stocks	1,155	20.7	24.1	9.6	18.8
Policy loans	784	10.4	19.3	15.0	3.3
Other	380	6.4	23.2	−14.6	− 5.7

e: Estimate.

* Relates to the life branch assets of all companies registered under the federal insurance acts and comprises major assets at book value physically held in Canada.

(1) Percentage increase over previous year-end.

SALES FINANCE AND CONSUMER LOAN COMPANIES. Most of the increase in the major assets of the sales finance and consumer loan companies in 1971 was concentrated in business receivables; consumer receivables continued to decline for most of the year. The increase in their lending was financed by the issue of long-term debt and borrowing from parent and affiliated companies; short-term paper and bank loans outstanding continued to decline.

SALES FINANCE AND CONSUMER LOAN COMPANIES MAJOR ASSETS AND LIABILITIES

	Millions of dollars Dec. 1971e(1)	Percentage Increase(2) Annual average 1966-68	1969	1970	1971e(1)
Total major assets(3)	5,323	6.0	14.5	− 2.7	3.6
Cash and investments	322	22.0	33.3	22.7	2.5
Gross receivables	5,097	5.4	13.7	− 3.8	3.7
Consumer receivables(4)	3,066	6.7	16.5	− 0.7	− 2.9
Business receivables(4)	2,031	5.9	9.8	− 9.0	15.6
Total major liabilities	4,090	5.2	14.7	− 5.2	0.1
Bank loans	232	−16.4	29.2	−33.3	−13.8
Short-term paper	1,363	13.4	17.5	− 8.5	− 3.3
Loans from parent and affiliated companies	792	4.8	19.7	− 9.0	1.7
Long-term debt (with an original term of more than one year)	1,703	6.4	6.4	7.9	4.5

e: Estimate.

(1) The estimates shown for December 1971 do not reflect the recent distribution of funds to the creditors of Atlantic Acceptance Corporation Limited.

(2) Percentage increase over previous year-end.

(3) Includes receivables net of allowance for bad debts.

(4) The percentage changes shown for 1969, 1970 and 1971 are not strictly comparable with those shown for the earlier period because of changes in the coverage of the series.

NET NEW SECURITY ISSUES

The total amount of funds raised in 1971 by both financial and non-financial borrowers through the issue of marketable securities was $4.6 billion, down slightly from $4.8 billion in 1970. However, $4.3 billion of that amount was purchased by Canadian residents compared with $4 billion in the previous year. The net issue of Canada Savings Bonds was much higher than in the previous year. Provincial and municipal securities acquired by Canada and Quebec

NET NEW SECURITY ISSUES

(millions of dollars)

	1969	1970	1971
Funds raised through net new issues:			
Canadian dollar issues of:			
Government of Canada(1)	— 46	1,278	466
Provinces and municipalities	74	999	1,438
Non-financial corporations	1,330	1,631	1,925
Sub-total	1,358	3,908	3,829
Financial institutions and others(2)	576	244	364
Total Canadian dollar issues	1,934	4,152	4,193
Foreign currency issues of:			
Government of Canada(1)	14	— 121	— 2
Provinces and municipalities	1,035	340	242
Non-financial corporations	568	421	130
Sub-total(3)	1,617	640	370
Financial institutions and others(2)	106	— 21	19
Total foreign currency issues	1,723	619	389
Total funds raised	3,657	4,771	4,582
Funds supplied by increase in holdings of:(4)			
Bank of Canada	170	183	571
Chartered banks	— 509	1,783	1,359
Non-bank financial institutions	1,271	1,527	2,407e
Other residents	775	507	— 23
Non-residents	1,950	771	268
Total funds supplied	3,657	4,771	4,582
Other security issues not included above:			
Canada Savings Bonds	324	714	2,519
Canada and Quebec Pension Plan funds — purchases of provincial and municipal securities	1,005	1,063	1,089e
	1,329	1,777	3,608e

e: Estimate.

(1) Outside Government of Canada accounts.

(2) Includes issues of educational and other public institutions not subject to governmental guarantee.

(3) This sub-total includes the Government of Canada foreign currency issues that were excluded from foreign currency borrowing by non-financial borrowers in the table on page 46.

(4) More details of the changes in security holdings of the major investors are given in Appendix Table IV.

Pension Plan funds, which are also excluded from the totals above, amounted to about $1.1 billion, $26 million more than in 1970.

The federal Government, which had accounted for nearly one quarter of the net new marketable issues in 1970, reduced its market borrowing by more than half in 1971 and accounted for only 10 per cent of net new marketable issues. Provinces and corporations both increased the absolute amount and their shares of total funds raised through securities markets.

Apart from the decline in non-resident net purchases of Canadian securities, the most important change in the distribution of net new issues in 1971 was the large increase in purchases of securities by non-bank financial institutions. These institutions concentrated their purchases in provincial, municipal and corporate bonds. The smaller purchase of securities by the chartered banks was largely due to their reduced acquisition of Government of Canada securities which more than offset the increase in their purchases of provincial, municipal and corporate securities.

While the non-financial resident public's holdings of Canada Savings Bonds rose very sharply in 1971 its holdings of marketable securities declined slightly; a reduction of $866 million in holdings of Government of Canada marketable securities and a decline in holdings of corporate stocks were not fully offset by a substantial increase in holdings of other securities.

NET CAPITAL INFLOW FROM ABROAD

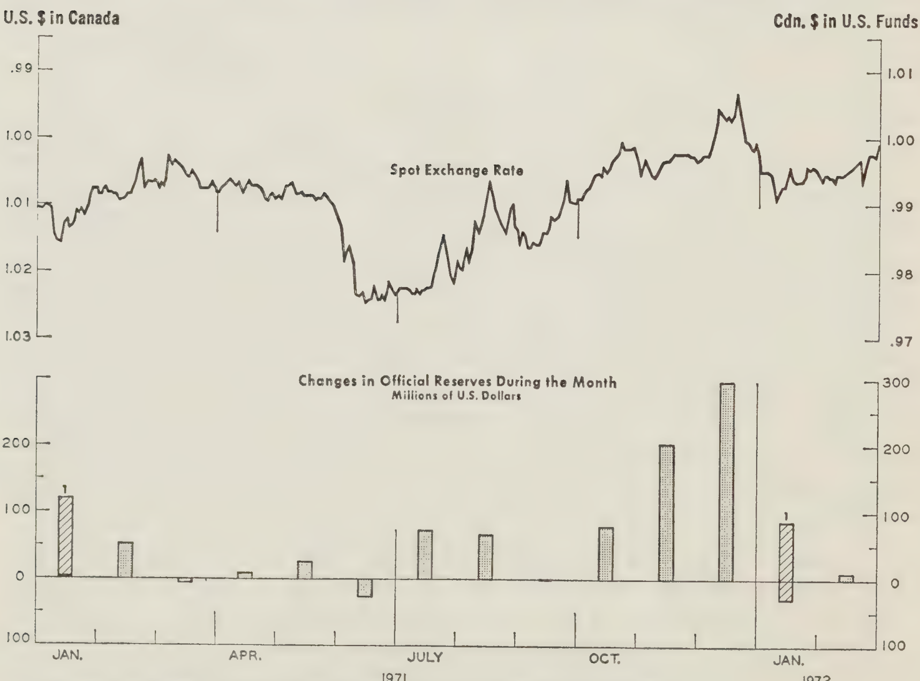
The shift to a surplus in the current account of the balance of payments and the consequent need to adjust the flows on capital account have already been discussed in previous sections of this Report. The central bank's policy of maintaining easy credit conditions in the domestic capital market facilitated this adjustment by reducing the incentive to borrow abroad. The yield differential between Canadian provincial bonds and public utility bonds in the United States shown in the chart on page 36, for example, was virtually eliminated by the end of 1970. Moreover, the Minister of Finance and the Bank of Canada urged borrowers to examine the domestic market carefully before going abroad to borrow. Net new issues of foreign currency bonds by provinces, municipalities and business corporations declined from $1,442 million in 1969 to $724 million in 1970 and to $430 million in 1971.

Largely as a result of the reduction in net new foreign currency bonds issued by Canadians, the net long-term capital inflow declined from $738 million in 1970 to $478 million in 1971. Short-term transactions produced a small net capital inflow for 1971. Of the components of short-term flows that can be identified, the reduction in resident holdings of foreign currency bank deposits led

to a net inflow of almost $1 billion and non-resident purchases of Canadian short-term bills and paper, which had caused an inflow in excess of $200 million in both 1969 and 1970, declined to $77 million in 1971. Unspecified short-term capital transactions appear to have resulted in an outflow of about $1 billion in 1971.

While the total net capital inflow (exclusive of changes in official reserves) increased modestly in 1971, there was a marked reduction in the current account surplus and additions to reserves were substantially less in 1971 than in 1970. On occasions when world exchange markets were very unsettled prior to the agreement reached in Washington in December, Canada's official reserves increased markedly. They reached a total of U.S. $5,570 million at the end of December 1971 compared with U.S. $4,679 million one year earlier. The increase during the year included the allocation of 118 million of Special Drawing Rights in January 1971. Changes in official reserves as well as the movements in the exchange rate of the Canadian dollar are shown in the chart below.

EXCHANGE RATE AND OFFICIAL RESERVES



1. Includes allocations of 118 million SDRs in January 1971 and 117 million in January 1972.

INTERNATIONAL CAPITAL FLOWS

(millions of dollars)

	1969	1970	1971
Foreign direct investment in Canada net of Canadian direct investment abroad	350	490	590
Canadian stocks:			
Net new issues	210	65	22
Trade in outstandings	53	− 147	− 157
Total	263	− 82	− 135
Canadian bonds:			
Gross new issues to non-residents	1,877	1,154	1,146
Retirements	− 438	− 483	− 726
Trade in outstandings	2	− 39	− 94
Total	1,441	632	326
Foreign securities — change in resident holdings	102	61	196
All other long-term capital	− 51	− 363	− 499
Total long-term capital	2,105	738	478
Purchase of Canadian bills and paper	246	221	77
Resident holdings of foreign currency bank balances and other short-term funds abroad	−1,587	− 376	992
Other short-term capital including errors and omissions	217	− 113	− 997
Total short-term capital	−1,124	− 268	72
Total capital flows	981	470	550
Increase in non-resident holdings of Canadian securities			
Stocks	263	− 82	− 135
Bonds	1,441	632	326
Short-term paper	246	221	77
Total	1,950	771	268

GENERAL PUBLIC HOLDINGS OF FINANCIAL ASSETS

The increased financing undertaken by major borrowers in 1971 along with the decline in borrowing abroad was reflected in substantial increases in the Canadian dollar financial asset holdings of the general public. As mentioned earlier in this Report, the important role played by the banks in accommodating the larger amount of financing undertaken in Canada in 1971 was reflected in

GENERAL PUBLIC HOLDINGS OF CERTAIN FINANCIAL ASSETS

	Millions of dollars Dec. 1971	Percentage increase(1)			
		Annual average 1966-68	1969	1970	1971
Currency	3,891	8.3	9.7	6.2	11.7
Chartered bank demand deposits	7,519	7.1	0.9	4.9	21.0
Sub-total	11,410	7.5	3.9	5.4	17.6
Other chartered bank Canadian dollar deposits(2)	23,905	14.3	3.3	13.6	13.6
Sub-total	35,315	11.9	3.5	10.9	14.9
Chartered bank foreign currency deposits of residents — swapped	732	11.6	103.3	8.9	−56.7
— other	965	24.3	34.2	−12.4	−35.7
Sub-total: currency plus all chartered bank deposits shown above	37,012	12.3	7.5	9.5	9.1
Credit unions and caisses populaires deposits	5,082e	13.5	9.4	12.8	21.7
Quebec savings bank deposits(2)	592e	9.6	7.9	7.7	11.3
Trust and mortgage loan company deposits	9,919e	11.1	13.5	14.8	14.0
Sub-total: obligations of the financial institutions shown above	52,605e	12.2	8.7	10.7	11.1
Short-term paper holdings of residents	2,833e	23.6	15.3	2.1	8.0
Canada Savings Bonds	9,916	2.7	5.1	10.7	34.1
General public holdings of liquid assets shown above	65,354e	11.1	8.5	10.3	13.9

e: Estimate.

(1) Percentage increase over previous year-end.

(2) For comparability the deposits of the bank operating under the Quebec Savings Bank Act which became a chartered bank in November 1969 are included with chartered bank deposits prior to that time.

the substantial increase in private holdings of currency and Canadian dollar chartered bank deposits. These are part of an array of liquid assets held by the general public and the table on the opposite page provides additional information on other liquid claims for which data are readily available.

GOVERNMENT OF CANADA DEBT MANAGEMENT OPERATIONS

As previously noted in the discussion of the Government of Canada's cash requirements, the sale of Canada Savings Bonds accounted for most of the net borrowing undertaken in 1971. Canada Savings Bonds outstanding increased by $2.5 billion in 1971 while net sales of marketable securities were significantly less than in 1970. There was a net increase of $205 million in treasury bills and $290 million in Canadian dollar marketable bonds in the year; of these amounts federal Government accounts acquired about $30 million.

The table on page 60 summarizes the major market operations of the Government of Canada in 1971 excluding three-month and six-month treasury bills issued at the regular weekly auctions. Over the year a total of $280 million was raised through additions to these bill issues. Special 364-day treasury bills (which are included in the table) were offered on three occasions, totalling $400 million against retirements of $475 million.

The Government borrowed in the domestic bond market on six occasions in 1971, mainly for the purpose of refunding maturing issues. Offerings of Canadian dollar marketable bonds were $2,370 million while retirements and cancellations amounted to $2,080 million of which $225 million were guaranteed (CNR) issues. Most of the new loans were of medium-term maturity and the average term on outstanding unmatured direct and guaranteed securities shortened over the year by three months, to five years and one month.

In addition to these loans an advance refunding of a portion of the 4¼ per cent bonds due September 1, 1972 formed part of the August 1 debt operation. Outstanding bonds amounting to $350 million of this maturity were exchanged for 6¼ per cent bonds due August 1, 1976 convertible into 7¼ per cent bonds due August 1, 1981. After this refunding, $717 million of the 4¼ per cent bonds due September 1, 1972 remained outstanding.

The 1971/72 series of Canada Savings Bonds offered investors an average yield of 7.19 per cent over a nine-year term and included an interest compounding option. Although the series was withdrawn from sale on November 26 its gross sales reached $2.6 billion and net sales in the fourth quarter amounted to a record $2.3 billion.

SUMMARY OF DIRECT AND GUARANTEED NEW ISSUES AND RETIREMENTS GOVERNMENT OF CANADA MARKETABLE SECURITIES*

Date	Issues offered	Amount delivered (millions of dollars par value)	Term to maturity	Yield to maturity	Amount retired (millions of dollars par value)
1971		(payable in Canadian dollars)			
Jan. 16					40[1]
Feb. 12	Treasury bills	125	364 days	4.98	125
Feb. 15	6¾% Feb. 15, 1989	150	18 yrs.	6.85	
Apr. 1	5% Apr. 1, 1974	100	3 yrs.	5.00	
	5½% Oct. 1, 1976	175	5 yrs. 6 mos.	5.50	
	6¼% Apr. 1, 1980	200	9 yrs.	6.40	
		475			425
May 14	Treasury bills	125	364 days	4.06	125
June 1	5% Apr. 1, 1974[2]	250	2 yrs. 10 mos.	5.15	
	5¾% June 1, 1976	125	5 yrs.	5.98	
	6½% June 1, 1979	100	8 yrs.	6.66	
		475			425
Aug. 1[3]	5¼% Dec. 15, 1972[4]	125	1 yr. 4½ mos.	5.13	
	5½% Dec. 1, 1974[5]	75	3 yrs. 4 mos.	6.00	
	6¼% Aug. 1, 1976[6]	350	5 yrs.	6.25	
		550			350
Oct. 1	5¼% Dec. 1, 1973	150	2 yrs. 2 mos.	5.25	
	5½% Oct. 1, 1976[7]	220	5 yrs.	5.91	
		370			370
Nov. 26	Treasury bills	150	364 days	3.60	225
Dec. 15	4¼% Dec. 1, 1974	125	2 yrs. 11½ mos.	4.36	
	5¾% Dec. 15, 1979	225	8 yrs.	5.87	
		350			463[8]
Dec. 31					7[9]
	Total bonds	2,370			2,080
	Total treasury bills*	400			475
		(payable in foreign currencies)			
Apr. 15					1[10]
Oct. 15					1[10]

* Excludes three-month and six-month treasury bills.

(1) Maturity of Canadian National Railway bonds: 2⅞% issued January 16, 1950.

(2) In addition to $100 million 5% April 1, 1974 already outstanding.

(3) Delivery date August 3. Accrued interest not payable.

(4) In addition to $100 million 5¼% December 15, 1972 already outstanding.

(5) In addition to $100 million 5½% December 1, 1974 already outstanding.

(6) Offered in exchange for equal par value of Government of Canada 4¼% bonds due September 1, 1972. Convertible at option of holder from August 1, 1975 to January 31, 1976 into an equal par value of 7¼% bonds dated August 1, 1976 and due August 1, 1981 giving a combined average yield of 6.66% for the full ten years beginning August 1, 1971.

(7) In addition to $175 million 5½% October 1, 1976 already outstanding.

(8) Includes $178 million of Canadian National Railway bonds: 5½% issued December 15, 1959.

(9) Cancellation by purchase funds of the following Canadian National Railway bonds: $1.8 million of 5% May 15, 1977; $2.0 million of 5¾% January 1, 1985; $3.5 million of 5% October 1, 1987.

(10) Partial redemption at par of U.S.-pay. 5% October 15, 1987 for the Sinking Fund.

Appendix Tables I to IV ▶

APPENDIX TABLE I

BANK OF CANADA ASSETS AND LIABILITIES

(monthly changes — millions of dollars)

	Government of Canada securities at book value	Net foreign currency assets	Investment in IDB	All other assets (net)	Note circulation	Canadian dollar deposit liabilities		
						Chartered banks	Government of Canada	Other
1971								
Jan.	+181	−123	+7	−71	−187	+172	+7	+1
Feb.	+1	−20	+3	−69	+2	−110	+23	−2
Mar.	−52	–	–	−68	+49	+11	−176	−5
Apr.	−21	–	+12	+99	+38	+53	−2	+1
May	+8	+122	–	−43	+112	+49	−75	+1
June	+102	−9	+2	+76	+98	+21	+52	–
July	+40	+91	+5	+32	+66	+32	+70	–
Aug.	+192	−113	+1	−14	+6	+95	−45	+11
Sept.	+60	−36	+1	−56	+3	−75	+54	−14
Oct.	−134	+15	+11	+80	+39	+38	−105	+1
Nov.	+123	+116	+1	−172	+67	−38	+39	+1
Dec.	+74	+15	–	+145	+179	+49	−3	+10
Total	+574	+57	+44	−61	+471	+296	−160	+6

APPENDIX TABLE II

BANK OF CANADA NET TRANSACTIONS IN GOVERNMENT OF CANADA SECURITIES IN 1971

(delivered basis — par value in millions of dollars)

	Net purchases from (+) or net sales to (−) investment dealers and banks(1)						
		Bonds(2)					
	Treasury bills	3 years & under	3 years to 5	5 years to 10	Over 10 years	Sub-total bills and bonds	Securities under PRA
Jan.	+149	–	–	–	–	+149	+ 81
Feb.	+ 76	–	–	–	+60	+136	− 88
Mar.	+ 8	–	–	–	–	+ 8	–
Apr.	+ 9	–	–	–	–	+ 9	–
May	+ 5	–	+ 3	− 3	+14	+ 19	–
June	+ 53	+13	− 1	−12	+ 1	+ 54	–
July	+ 10	–	+ 2	− 2	–	+ 10	–
Aug.	+ 73	–	+ 43	–	–	+116	+ 29
Sept.	+ 81	+ 1	–	− 1	–	+ 81	+ 41
Oct.	+ 45	–	–	–	–	+ 45	− 70
Nov.	+ 25	–	–	–	–	+ 25	+140
Dec.	+119	+62	+ 53	–	–	+234	−140
Total	+653	+76	+100	−17	+75	+887	− 7

(1) Advances by the Bank of Canada to the chartered banks were outstanding on 27 business days and purchase and resale agreements with money market dealers were outstanding on 78 business days. Over the year as a whole, the average daily amount of advances outstanding was $664,000 and the average daily amount of securities held by the Bank of Canada under purchase and resale agreements was $16.0 million.
(2) Classified by years to maturity at time of transactions.

Net transactions with Government and other client accounts								
Purchases (+) of new issues less matured holdings		Net purchases from (+) or net sales to (−)				Net change in holdings of Government of Canada securities		
		Securities Investment Acct.		Other Government and client accounts				
bills	bonds	bills	bonds	bills	bonds	bills	bonds	total
+ 17	–	–	–	− 64	− 2	+139	+ 42	+181
− 54	+ 25	–	–	− 17	− 1	− 35	+ 37	+ 2
− 32	–	–	–	− 32	− 1	− 55	− 1	− 56
− 3	+ 11	–	–	− 32	− 6	− 26	+ 5	− 21
+ 40	–	–	–	− 34	−14	+ 11	–	+ 11
+ 29	+ 53	–	–	− 31	− 3	+ 52	+ 50	+102
+101	–	–	–	− 61	− 9	+ 50	− 9	+ 41
+ 18	+ 51	–	–	− 22	–	+ 90	+101	+191
− 17	–	–	–	− 46	–	+ 39	+ 19	+ 59
− 24	− 10	–	–	− 63	−13	− 85	− 49	−134
− 2	–	–	–	− 40	–	+ 26	+ 96	+123
+ 41	+ 4	–	–	− 59	− 5	+ 57	+ 17	+ 74
+114	+133	–	–	−499	−55	+265	+308	+573

APPENDIX TABLE III

GOVERNMENT OF CANADA FINANCIAL ACCOUNTS

(millions of dollars)

	Calendar 1969	Calendar 1970	Calendar 1971
1. Budgetary surplus (—) or deficit	−605	165	688
Adjustments for national accounts basis:			
Funds borrowed (—) from:			
Public service superannuation accounts	−591	− 679	− 737
Unemployment insurance and old age security funds	−132	166	− 40
All other adjustments to national accounts basis (net)	555	360	439
2. National accounts basis surplus (—) or deficit	−773	12	350
3. Increase in major loans and advances to:			
Central Mortgage and Housing Corporation	468	552	711
Farm Credit Corporation	96	57	27
CNR (incl. Air Canada, excl. debt refunding)	85	144	146
Export Development Corporation	35	51	112
Municipal Development and Loan Fund	− 6	− 9	− 9
Canadian Broadcasting Corporation	15	19	25
Canada Development Corporation	–	–	25
National governments	37	79	98
Provincial governments	67	32	111
Other	57	50	61
Sub-total	854	975	1,307
4. Canadian dollars required to finance increase in Government's foreign currency assets (or reduction in liabilities):			
Advances to the Exchange Fund	−207	1,399	1,048
Holdings of IBRD and Columbia River Treaty bonds	− 32	− 32	− 26
Subscriptions and advances to international agencies	30	379	41
Foreign-pay securities (outside Gov't accounts)	− 14	121	2
Demand notes payable to international agencies	229	− 301	− 382
Sub-total	6	1,566	683
5. Funds required for net increase in other assets or reduction in other liabilities:(1)			
Refundable corporation tax	110	44	2
Excess of accrued corporation income tax over collections(2)	−475	− 405	20
All other assets and liabilities	−119	− 285	− 200
Sub-total	−484	− 646	− 178
6. Total Canadian dollar financing requirements (sum of items 2, 3, 4 and 5)	−397	1,907	2,162
7. Total Canadian dollar financing requirements were met by:			
Increase (+) in Canadian dollar marketable securities outside Government accounts	− 46	1,278	466
Increase in Canada Savings Bonds outstanding	324	714	2,519
Reduction (+) in Canadian dollar cash balances	−675	− 85	− 823
Total (= Item 6)	−397	1,907	2,162

(1) Apart from those shown in Item 7.

(2) A contra amount is included in "All other adjustments to national accounts basis (net)" shown in Item I.

APPENDIX TABLE IV

NET NEW SECURITY ISSUES AND CHANGES IN HOLDINGS OF SECURITIES

(millions of dollars)

	1969	1970	1971
Net new security issues by:[1]			
Government of Canada[2]	— 32	1,157	464
Provinces and municipalities	1,109	1,339	1,680
Corporations: bonds[3]	990	1,677	1,869
short-term paper	598	253	257
stocks	992	345	312
Total	3,657	4,771	4,582
(of which: non-financial borrowers)	(2,975)	(4,548)	(4,199)
Increases in holdings of:			
Bank of Canada			
Government of Canada	170	183	571
Chartered banks			
Government of Canada market issues	— 482	1,510	721
Provincial and municipal securities	— 23	107	212
Corporate securities	— 4	166	426
Total chartered banks	— 509	1,783	1,359
Non-bank financial institutions			
Government of Canada market issues	105	— 51	80e
Provincial and municipal securities	194	399	835e
Corporate bonds and short-term paper	150	657	777e
Corporate stocks	822	522	715e
Total non-bank financial institutions	1,271	1,527	2,407e
Other residents			
Government of Canada market issues	166	— 263	— 866
Provincial and municipal securities	— 104	456	302
Corporate bonds and short-term paper	806	409	809
Corporate stocks	— 93	— 95	— 268
Total other residents	775	507	— 23
Non-residents			
Government of Canada market issues	9	— 222	— 42
Provincial and municipal securities	1,042	377	331
Corporate bonds and short-term paper	636	698	114
Corporate stocks	263	— 82	— 135
Total non-residents	1,950	771	268

e: Estimate.

(1) Excludes Canada Savings Bonds and provincial and municipal securities purchased by Canada and Quebec Pension Plan funds.

(2) Outside Government of Canada accounts.

(3) Includes issues of educational and other public institutions not subject to governmental guarantee.

BANK OF CANADA STATEMENT OF INCOME AND EXPENSE

YEAR ENDED DECEMBER 31, 1971

(with comparative figures for 1970)

(thousands of dollars)

	1971	1970
Income		
Revenue from investment and other income	$292,583	$274,349
Expense		
Salaries[1]	$ 8,985	$ 7,563
Contributions to pension and insurance funds	2,423	1,877
Other staff expenses[2]	624	560
Directors' fees	29	28
Auditors' fees and expenses	124	105
Taxes – municipal and business	1,579	1,475
R.C.M.P. guards and security protection	88	278
Bank note costs	7,138	7,611
Data processing and computer costs	558	486
Maintenance of premises and equipment – net	2,260	1,148
Printing and other costs of publications	224	157
Other printing and stationery	301	262
Postage and express	316	274
Telephones and telegrams	291	268
Travel and staff transfers	296	344
Interest on unclaimed balances	92	83
Other expenses	378	361
	$ 25,706	$ 22,880
Depreciation of buildings and equipment	1,383	1,176
Net Income Paid to Receiver General for Canada	265,494	250,293
	$292,583	$274,349

(1) The number of staff averaged 1,169 in 1971 and 1,106 in 1970.
(2) Includes overtime pay, medical services and cafeteria expenses.

ASSETS

	1971	1970
Deposits in foreign currencies:		
Pounds sterling and U.S.A. dollars	$ 42,904	$ 57,750
Other currencies	232	203
	43,136	57,953
Cheques on other banks	306,802	335,697
Advances to chartered and savings banks	2,000	
Accrued interest on investments	74,225	64,416
Bills bought in open market, not including treasury bills, at cost	997	
Investments — at amortized values:		
Treasury bills of Canada	885,232	621,193
Other securities issued or guaranteed by Canada maturing within three years	1,769,770	1,702,569
Other securities issued or guaranteed by Canada not maturing within three years	2,160,511	1,917,503
Debentures issued by Industrial Development Bank	457,874	415,599
Securities issued by the United Kingdom and the United States of America	214,513	136,534
Other securities	2,633	2,633
	5,490,533	4,796,031
Industrial Development Bank:		
Total issued share capital, at cost (note)	56,000	54,000
Bank premises:		
Land, buildings and equipment Cost less accumulated depreciation	22,206	28,580
Net balance of Government of Canada collections and payments in process of settlement	21,376	64,785
Other assets	1,506	3,527
	$6,018,781	$5,404,989

Note: The audited financial statements of the Industrial Development Bank as of September 30, 1971 show an equity of $78,218,684 at which date the Bank of Canada's investment in the share capital was $55,000,000.

L. RASMINSKY, Governor
Ottawa, Canada, January 26, 1972.

A. ROUSSEAU, Chief Accountant

AS AT DECEMBER 31, 1971
(with comparative figures as at December 31, 1970)
(thousands of dollars)

LIABILITIES

	1971	1970
Capital paid up	$ 5,000	$ 5,000
Rest fund	25,000	25,000
Notes in circulation	4,103,423	3,632,317
Deposits:		
Government of Canada	68,365	227,968
Chartered banks	1,472,816	1,176,434
Other	43,964	37,951
	1,585,145	1,442,353
Liabilities in foreign currencies:		
Government of Canada	38,750	32,255
Other	304	332
	39,054	32,587
Bank of Canada cheques outstanding	257,621	264,981
Other liabilities	3,538	2,751
	$6,018,781	$5,404,989

Auditors' Report • We have examined the statement of assets and liabilities of the Bank of Canada as at December 31, 1971 and the statement of income and expense for the year then ended. Our examination included a general review of the accounting procedures and such tests of accounting records and other supporting evidence as we considered necessary in the circumstances.

In our opinion these financial statements present fairly the financial position of the Bank as at December 31, 1971 and the results of its operations for the year then ended.

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of Clarkson, Gordon & Co.

MAURICE SAMSON, C.A.
of Samson, Bélair, Côté, Lacroix et Associés

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OTTAWA, ONTARIO
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BANK OF CANADA

ANNUAL REPORT OF THE GOVERNOR TO THE MINISTER OF FINANCE

AND STATEMENT OF ACCOUNTS

FOR THE YEAR 1972

Bank of Canada · Banque du Canada   Ottawa K1A 0G9

February 28th, 1973.

The Hon. John N. Turner, P.C.,
Minister of Finance,
Ottawa, Ontario.

Dear Sir,

In accordance with the provisions of the Bank of Canada Act I am transmitting herewith my report for the year 1972 and a statement of the Bank's accounts for this period, signed and certified in the manner prescribed in the by-laws of the Bank.

Yours very truly,

Governor

LOUIS RASMINSKY, C.C., C.B.E.
Governor of the Bank of Canada
1961 – 1973

Mr. Louis Rasminsky retired as Governor of the Bank of Canada on February 1, 1973. He was appointed Governor on July 24, 1961 and reappointed in 1968.

Over a period of thirty-three years of distinguished service with the Bank, including the last twelve as its Governor, Mr. Rasminsky's contributions in the field of Canadian economic policy and international monetary affairs have been of the highest order. Prior to joining the Bank in 1940 he served with the League of Nations, and his career as an outstanding international and Canadian public servant now spans a total of forty-three years.

BANK OF CANADA

Report of the Governor – 1972

The Annual Report of the Governor of the Bank of Canada is prepared pursuant to Section 26(2) of the Bank of Canada Act which requires that the Bank transmit to the Minister of Finance a statement of its accounts for the financial year "together with such summary or report by the Governor as he may deem desirable or as may be required by the Minister". In the past the Report has served not only to explain the policy that the Bank has followed and to communicate views of the Governor on current problems in the economy, but also to provide detailed reviews of economic and financial developments in Canada and abroad. For over a year now, however, articles on such developments have been published regularly in the monthly Bank of Canada Review under the direction of an Editorial Board, and it is the intention of the Bank to continue this practice. As a consequence, that part of the Report dealing with the economic background is less detailed than in recent years.

Some Highlights of the Year

The economic expansion that began just over two years ago continued during 1972, and output and employment again increased substantially. The performance of the economy was less satisfactory than had been hoped for, however, as unemployment remained high and prices rose more rapidly than in the previous year.

Official national accounts estimates for the full year 1972 are not yet available, but it would appear that the gain in Gross National Product in real terms approached the 5½ per cent increase recorded for 1971. At the time of writing this Report it is not possible to be more precise because 1972 was a year in which the problems of reconciling all of the information normally relied upon in making such estimates have been more than usually difficult.

The growth of output would have been greater had it not been for setbacks during the summer. In the third quarter, work stoppages had a particularly disruptive effect on production and trade, and bad weather reduced agricultural output. After August, however, industrial activity rebounded strongly and total output in the economy was growing very rapidly in the closing months of the year. External markets for the products of our basic resource industries, many of which had remained relatively weak during the earlier stages of the recovery, improved greatly over the course of the year in response to the strong rise in economic activity in progress in the United States and the resumption of more vigorous growth in Japan and Europe. Thus, a strong and broadly based expansion now appears to be under way in Canada, supported by stimulative demand management policies at home and by rising activity in the United States and overseas.

It is not clear at this time whether the gain in real output in 1972 was any greater than the normal growth of the economy's potential. In any event, the increase of just over 3 per cent in employment was matched by the continued rapid growth of the labour force and the unemployment rate averaged 6.3 per cent, almost as high as in the previous year. Indeed, on a seasonally adjusted basis unemployment reached a peak of 6.9 per cent of the labour force in September, though by January 1973 it had dropped back to 6.2 per cent.

Although there is undoubtedly too much slack in the economy, there is, at the same time, some reason to believe that unemployment rates may no longer

reflect the same degree of ease in labour markets as they formerly did. It has always been the case that in the Canadian labour market bottlenecks and shortages tend to emerge in certain areas of the country and in certain industries while the average national level of unemployment is still relatively high. However, the numerous reports of employers finding difficulty in hiring workers in 1972 at a time when the reported unemployment figures were higher than at any time since the beginning of the sixties suggest that some new element has been affecting the situation. In particular, changing income maintenance arrangements may be tending to increase the number of those who are reported as remaining in the labour force but who want jobs only from time to time, and may be lessening the urgency with which others seek re-employment. This latter factor may also have had some effect on employment and output in industries that apparently had difficulty in filling vacancies in 1972.

In view of the implications of such questions for economic policy in general and for demand management policies in particular, there is an urgent need for additional information and analysis in this area. Demand management policies, including monetary policy, require that judgments be made about how much room there is for the economy to expand at above-normal rates of growth. Labour force statistics are normally relied on to provide some of the most relevant information for such judgments. I therefore welcome both the recently announced decision of Statistics Canada to devote increased resources to expanding the statistical information on the labour force and the intention of the Economic Council of Canada to undertake a special study of the labour market.

The more rapid rise of prices in Canada in 1972 was disquieting. To an important extent this trend reflected world-wide influences that were pushing up prices of many basic foodstuffs and a number of other primary products. These external developments contributed to unusually large increases in Canada in food prices and in the cost of residential building materials. On balance, however, prices of other goods and services in Canada also increased somewhat more rapidly than in the previous year, and this occurred despite the absence of any general pressure on productive capacity in the economy. While many other countries, especially in Europe, had even more serious cost and price problems of this kind in 1972, our most important trading partner, the United States, did considerably better than we did.

The major external influence on the Canadian economy over the past year was the marked acceleration of business activity in the United States. The rates of growth in the other major industrial countries also picked up during the year. These developments were reflected in our export trade. Despite rather sluggish markets overseas for primary industrial commodities until late in the year total exports increased by 12 per cent. However, the rise in imports of 20 per cent outpaced the rise in exports by a substantial margin, and the current account of

Canada's balance of payments moved back into deficit. The high rate of import growth lessened the impact of the strong gain in domestic demand on Canada's output and employment in 1972.

By January 1973 rapid economic expansion in the United States had reduced the unemployment rate in that country from 6 per cent of the labour force in January 1972 to 5 per cent. The U.S. economy has now developed so much momentum that the concern of the authorities has shifted towards containing the expansion and maintaining an improved price performance. The essence of their problem is to move smoothly and in good time from the recent very high rate of economic growth to a rate that can be sustained over the longer run.

In February of this year foreign exchange markets in a number of countries around the world were once again dominated by a sharp fall in confidence in exchange rates arising from the fact that the massive imbalance in world trade and payments that developed in the latter part of the 1960s has yet to be corrected. The United States continues to have a very large deficit in its balance of international payments on current account, while Japan, as well as the continental members of the European Economic Community taken as a group, continue to have very large current account surpluses. Strong forces in the direction of adjusting these imbalances were at work in 1972, including the realignment of exchange rates that followed the Smithsonian meeting in December 1971 and the much better recent trend of prices and costs in the United States than elsewhere. Their influence was, however, temporarily offset by other forces, including the perverse initial impact of exchange rate changes on the value of trade flows and the fact that the timing of the business cycle in the major trading countries was very unfavourable to the required adjustment. While the turbulence in world currency markets this year has been a matter of concern, the further major adjustment of exchange rates in February 1973 should help to restore more orderly conditions and in time can be expected to add substantial new strength to the forces operating to correct the underlying imbalance.

Improved arrangements for achieving and maintaining international payments equilibrium are now under study by an ad hoc Committee of the Board of Governors of the International Monetary Fund, known as the Committee of Twenty on International Monetary Reform and Related Matters. The Committee is composed of Finance Ministers, one of whom is the Minister of Finance for Canada. With the help of a Committee of Deputies it is examining all aspects of international monetary reform.

The prospects for a sustained and orderly expansion of world trade in the future are closely linked to the progress made towards an acceptable world structure of balances on current account. Canada's interest in encouraging such progress is clear. It is also clear that Canada's international balance on current

account is not contributing to this problem. This may not seem evident if only trade in goods is considered, but trade in services is equally relevant, and a large deficit on service account is a predominant feature of Canada's balance of international payments. Our balance on all current account transactions did move into appreciable surplus in 1970, but it has since weakened and is again in deficit.

While an acceptable world structure of balances on current account is the goal of present initiatives to adjust countries' payments positions, that structure will not be viable unless it is matched by appropriate international flows of capital. It is mainly in this area, that of achieving a balance on capital account appropriate to the balance on current account, that Canada has had a problem in recent years.

Both internal and external considerations influenced the monetary policy followed during 1972. It was apparent that large increases in demand, output and employment would be needed for a time in Canada if the economy was to regain more satisfactory operating levels. This was the dominant consideration underlying the expansionary policy followed, but in seeking to maintain relatively easy conditions in Canadian financial markets the Bank also had in mind the potentially dampening effects on economic expansion of an undue appreciation of the foreign exchange value of the Canadian dollar that would arise from an excessive inflow of capital from abroad. While giving priority to the immediate objective of reducing the margin of slack in the economy, the Bank remained aware of the time-lags involved in the operation of monetary policy, and for this reason it kept the liquidity of the banking system under close control.

The forward thrust of the economy now appears to be strong and expansionary demand policies are being pursued to try to ensure that excess slack is taken up. A situation of this character inevitably involves a risk that at a later stage of the expansion aggregate demand may grow too strongly and cause general demand pressure on prices and costs to develop. As the expansion proceeds it will be important to guard against this danger. In Canada, as in other countries, there is already a certain amount of "built-in" inflation and this will not be easy to reduce even over a considerable period of time. It would be unfortunate indeed if instead the underlying rate of inflation were to be ratcheted up yet another notch.

Monetary Policy and Financial Developments

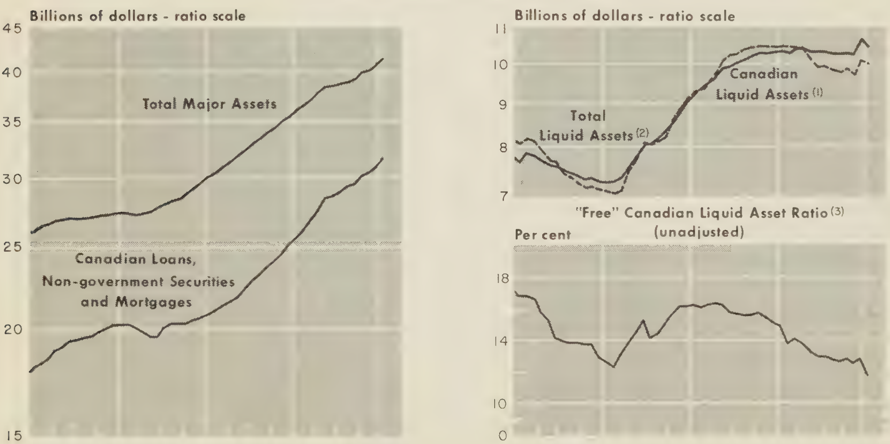
The general character of the monetary policy followed in 1972 is readily apparent from the behaviour of most monetary aggregates and indicators of credit conditions.

There was a further large increase of 15 per cent in chartered bank major assets during 1972, following the 19 per cent increase recorded in the previous year. The asset growth of the banking system was again particularly striking in areas such as term loans to business and mortgage lending, where the banks have continued to increase their share of the market. Even apart from these competitive gains, however, it is apparent that bank lending activity has been in a phase of rapid and sustained growth for almost three years.

By contrast, the chartered banks' total holdings of Canadian earning liquid assets were no higher at the end of 1972 than a year earlier. This reflected the continuation through 1972 of the policy of close control of chartered bank liquidity adopted by the Bank of Canada in mid-1971. As a result, bank holdings of Canadian dollar liquid assets in excess of their primary and secondary reserve requirements—their "free" Canadian liquid assets—declined as a proportion of their total assets from 15.2 per cent in December 1971 to 12.8 per

CHARTERED BANK ASSETS AND LIQUIDITY

Average of Wednesdays, Seasonally Adjusted



(1) Canadian liquid assets include cash, Government of Canada securities, day-to-day loans and call loans.

(2) Total liquid assets include Canadian liquid assets and net foreign assets.

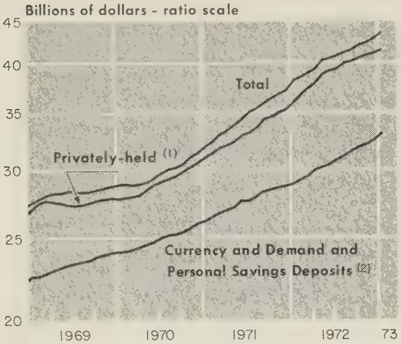
(3) Ratio of Canadian liquid assets in excess of primary and secondary reserve requirements to total major assets.

cent a year later. The net foreign currency assets of the banks also declined substantially during 1972, mainly in the first half of the year.

There was a further substantial increase of 16 per cent in aggregate holdings of currency and chartered bank Canadian dollar deposits by the general public over the course of the year. This increase in the public's liquidity was an important factor in the ready accommodation by financial institutions and markets of the large credit demands associated with rising economic activity.

The total amount of funds raised by Canadian non-financial borrowers in 1972 is estimated to have reached a slightly higher level than in 1971. There were further sizeable increases in consumer and mortgage borrowing and in funds raised by provincial and municipal governments and their enterprises. Non-financial business borrowed less than in 1971 when this sector appears to have added to its holdings of financial assets on a particularly large scale. Borrowing by the Government of Canada also declined in 1972. Although the Government's financial requirements, excluding foreign exchange financing, were of roughly the same order in each calendar year, the use of Canadian dollars to finance purchases of foreign exchange was considerably smaller in 1972. There was also a much smaller increase in the Government's cash balances in 1972 than in the previous year.

CURRENCY OUTSIDE BANKS AND CHARTERED BANK DEPOSITS
Average of Wednesdays, Seasonally Adjusted



(1) Excludes Government of Canada deposits.
(2) Excludes non-personal term and notice deposits.

FUNDS RAISED BY MAJOR NON-FINANCIAL BORROWERS

(billions of dollars)

	1969	1970	1971	1972
Consumers	1.3	0.7	1.4	2.1
Mortgage borrowers(1)	1.7	1.5	2.5	3.8
Provinces and municipalities(2)	2.2	2.3	2.9	3.3
Non-financial business	4.2	3.2	5.3	4.5
Sub-total	9.4	7.7	12.1	13.7
Government of Canada	0.3	2.0	3.0	1.6
Total	9.7	9.7	15.1	15.3

(1) Excludes net mortgage lending by governments and their agencies, notably CMHC, which is reflected in the financing requirements of the respective governments.
(2) Includes government enterprises. Loans from the Government of Canada are excluded.

The financing of these total borrowings in 1972 involved somewhat smaller net sales of marketable securities than in 1971, and there was also a substantial decline in the net sale of Canada Savings Bonds from the unusually high level reached in 1971. On the other hand, the strong growth of loans and mortgages was reflected in rapid expansion of the assets of all major types of financial institutions; in total their assets increased at the same rate as in 1971.

MAJOR ASSETS OF FINANCIAL INSTITUTIONS[1]

	Billions of dollars Dec. 1972	Percentage increase Dec. 1970 to Dec. 1971	Percentage increase Dec. 1971 to Dec. 1972
Deposit-taking institutions			
Chartered banks	41.4	19	15
Quebec savings bank	0.7	13	10
Trust and mortgage loan companies	12.6	13	15
Credit unions and caisses populaires	6.7	22	28
Sub-total	61.4	18	16
Contractual savings institutions			
Life insurance companies	16.8	7	7
Pension funds	13.7	12	11
Sub-total	30.5	9	9
Sales finance and consumer loan companies	6.0	5	13
Total	97.9	14	14

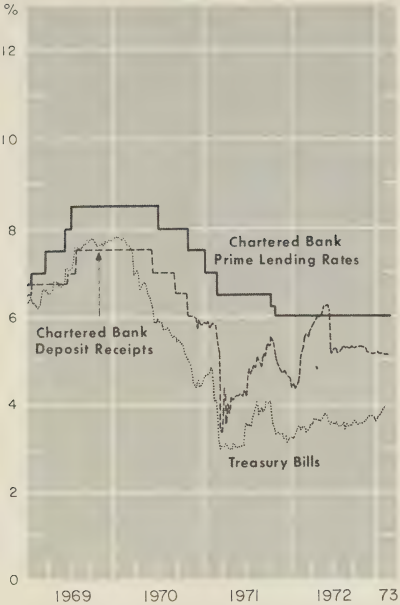
(1) Figures for December 1972 are estimated except for banks.

On the whole, credit demands in 1972 were accommodated without any major, sustained upward movement in Canadian interest rate levels. Although most long-term interest rates rose appreciably in the course of the first half of 1972, these increases were not fully maintained. By year-end, for example, mortgage rates had receded somewhat from the levels reached several months earlier. The upward movement of short-term interest rates in Canada was more pronounced, but was reversed abruptly around mid-year. These rates have since tended to remain relatively low while comparable short-term rates in the United States have moved sharply higher.

For a time during 1972 the risk of heavy capital inflows from abroad putting undue upward pressure on the exchange rate for the Canadian dollar was a source of concern. With Canadian borrowers continuing to issue a high volume of long-term debt and with terms of access to funds in foreign financial markets

INTEREST RATES
CANADA

SHORT-TERM
3-month

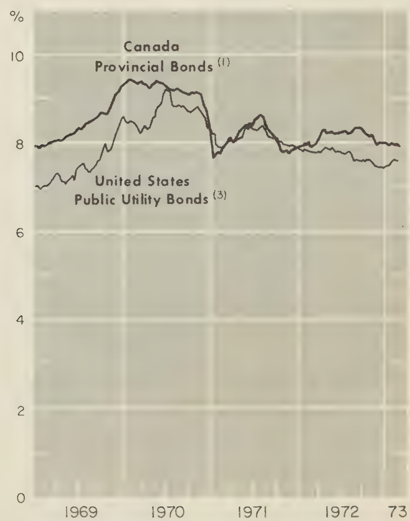


LONG-TERM

CANADA - UNITED STATES COMPARISONS

SHORT-TERM
3-month

LONG-TERM



(1) Wednesday average yield on the 10 provincials included in the monthly series published by McLeod, Young, Weir and Co. Ltd.

(2) Wednesday average yield on bonds with a maturity of 10 years or over.

(3) Wednesday average yield on 40 public utility bonds, published by Moody's Investors Services.

being relatively attractive, there was a substantial increase in net new issues of bonds sold to non-residents. A particularly heavy concentration of such sales occurred during a brief period in the spring. In conjunction with other influences including the rather unusual developments described below, this led to a further temporary appreciation of the Canadian dollar in foreign exchange markets. The easing of these pressures on the Canadian dollar in June was most welcome. The Bank continues to support the Minister of Finance's request to Canadian borrowers that they explore the domestic market carefully before offering issues for sale abroad.

Although there was little change in the broad objectives of monetary policy in Canada during the course of 1972, the situation that developed in financial markets in the first half of the year presented difficulties of a rather unusual kind which were subsequently resolved by the so-called "Winnipeg agreement" in June.

At the beginning of the year when bank loans were rising very rapidly, the Bank of Canada held the cash reserves of the chartered banks at levels intended to reduce bank liquidity and thus to moderate the pace of monetary expansion. The banks' holdings of liquid assets declined in the course of January and February and, given the strength of bank credit demands, the banks began to bid aggressively for deposit funds. Increases in the rates offered by banks on short-term deposits contributed to the upward movement of short-term interest rates that began in February. Although cash reserves were eased at times of particular pressure on markets and the Bank of Canada also moderated the decline in security prices through open market purchases, interest rates continued to rise in succeeding months. In the United States, short-term interest rates also rose during the period but, because the increase began later than in Canada and was much less pronounced, the differentials in rates widened quite sharply and there was upward pressure on the Canadian dollar in exchange markets.

In the spring the process of escalation of Canadian short-term interest rates began to feed on itself and to distort financing patterns. Short-term interest rates—including those offered on bank deposits—rose further, while the banks' prime lending rates remained unchanged at 6 per cent. Thus it became increasingly attractive for those with funds to invest to place them on short-term deposit with the banks, and correspondingly attractive for large borrowers to use bank credit rather than to issue short-term paper in the market. The increase in bank loans accelerated to an extraordinarily high rate in May when the banks' deposit rates on large blocks of short-term funds actually rose above their prime lending rates. The banks' fixed-term deposits (and those measures of the "money supply" that include such deposits) also rose dramatically, while the outstanding amount of short-term paper declined.

These distortions in financial markets were discussed in May and June during regular meetings with representatives of the chartered banks. In June the banks requested and received the concurrence of the Minister of Finance, in accordance with Section 138 of the Bank Act, to an agreement that rates of interest offered on deposits of $100,000 or more for terms up to 364 days would be limited to a maximum of 5½ per cent.

When the agreement came into effect on June 12 the whole structure of short-term interest rates in Canada declined, and there was also some reversal of the previous appreciation of the Canadian dollar in exchange markets.

For a time the Bank of Canada maintained relatively easy levels of cash reserves in order to facilitate the necessary readjustments in financial markets. By August, the distortions that had developed prior to the June agreement had been pretty well removed. As can be seen in the accompanying table, the annual rate of growth of bank loans, mortgages and similar investments returned to around 20 per cent, following a transitional period of slow growth during which short-term paper business was moving back into the market. The Bank of Canada also re-established more conservative levels of bank cash reserves in order to maintain close control of bank liquidity while permitting the underlying demand for bank credit to be accommodated without strain.

The extent to which the distortions discussed above affected the trend of total bank deposits is also shown in the table. Fixed-term deposits rose very sharply during the first part of the year and then declined, although remaining well above their level in 1971. These deposits are the dominant component of "non-personal term and notice deposits". The total of other privately-held Canadian dollar bank deposits and currency rose at a fairly steady annual rate of about 13 per cent during 1972.

SELECTED BANKING AND MONETARY STATISTICS

(percentage increase at annual rates, average of Wednesdays)

	Dec. 1970 to Dec. 1971	Dec. 1971 to Dec. 1972	Dec. 1971 to May 1972(1)	May 1972 to July 1972(1)	July 1972 to Jan. 1973(1)
Canadian liquid assets	14	4	–	3	2
Loans, mortgages and other investments	21	23	37	8	20
Total assets	19	15	23	3	15
Currency and Canadian dollar deposits					
Total	18	15	22	5	14
Privately-held	15	16	26	10	11
Non-personal term and notice deposits	39	30	90	– 1	– 2
Other(2)	11	13	13	13	15

(1) Based on seasonally adjusted data.
(2) Currency, demand deposits and personal savings deposits.

The introduction of the chartered bank agreement on deposit rates of interest proved to be a useful initiative. The situation of overly aggressive competition for deposits among banks had resulted in an abnormal structure of interest rates and distortions in credit flows, and had contributed to an undesirable appreciation of the Canadian dollar. The agreement arrested the process and helped to restore a calmer atmosphere.

This is not the first occasion when competition among banks for large blocks of short-term funds has been pushed to extremes and some limitation has seemed desirable. Nor has the phenomenon been peculiar to Canada. It may well be that the banking industry is particularly vulnerable to this type of extreme competition. Because funds in a money market are so highly mobile, a bank that fails to compete on deposit rates will very quickly lose funds on a large scale.

Arrangements to control undue competition for deposits are not uncommon in other countries and it appears to be the case that in Canada an arrangement of the kind we now have can be useful at least on occasion. However, agreements on interest rates that are rigid over time are not an ideal feature of financial markets for they can obstruct normal market forces and inhibit adjustments to changing circumstances. Care must be taken to ensure that they serve to prevent undesirable distortions, not to create them.

Since the end of the summer both the banks' general loans and a somewhat broader measure of credit extended that includes short-term market paper as well as bank loans (and which, therefore, is not distorted by shifts in the sources of credit of the kind that occurred last year) have been rising at an annual rate of around 18 per cent. Although this is lower than the 25 per cent rate of increase in this broader measure during the year or so prior to mid-1972 when borrowing demands seem to have been particularly strong, it is still high. At the same time the banks have been adding rapidly to their other loans and mortgage holdings. Other credit flows have also been substantial and have been readily accommodated.

During October and November some decline occurred in rates of interest on long-term bonds and mortgages, a decline encouraged by foreign interest in such investments and by the success of the 1972 Canada Savings Bond campaign. To some extent this easing of interest rates may also have reflected market reactions to evidence of earlier weakness in the economy. The result was some narrowing of long-term interest rate differentials between Canada and the United States. Meanwhile, at the short end of the market there has been a greater change in international differentials resulting from recent sharp increases in U.S. and Euro-dollar short-term interest rates. Some upward adjustment of rates of interest on Government of Canada treasury bills and short-term bonds has occurred, but on the whole these have not been large and Canadian short-term interest rates remain at comparatively low levels.

Review of the Economy

The record of the performance of the economy in 1972 is not complete as this Report is being written. In particular, preliminary official estimates of the National Accounts for the fourth quarter together with any revisions to earlier quarters are not yet available. However, the information at hand suggests that the Gross National Product expanded by some 10 per cent in value terms following an increase of about 9 per cent in the previous year. The increase in the over-all price deflator was apparently somewhat greater than 4½ per cent compared with 3¼ per cent in 1971. Thus the estimated gain in GNP in volume terms would appear to have approached the 5½ per cent increase registered in 1971.

One of the important and rather special influences on both output and prices in 1972 was a fairly sharp decline in agricultural production, after a very strong increase in the preceding year. The decline of about 10 per cent was attributable to a number of factors. The wheat crop was of lower average quality than in the previous year, other western grain crops were generally smaller, there were generally unfavourable growing conditions in eastern Canada, and hog production was at a cyclical low. These developments, occurring at a time of general imbalance between supply and demand in world markets for many basic agricultural products, contributed to a sharp rise in agricultural prices in Canada, a drawing down of farm inventories, and an appreciable rise in farm income on a cash basis.

The pattern of activity in the rest of the economy during the year was quite uneven, mainly because of major work stoppages which dislocated production and trade at various times, particularly during the summer. The number of man-days lost through labour disputes was in excess of 8 million, a new record and over 2½ times the figure for 1971. Beginning early in the year, strikes disrupted air transportation for a time and in the spring there was a brief strike involving most Quebec public servants including teachers and hospital employees. In the summer, severe dislocations of the normal flow of foreign trade were caused by maritime strikes here and abroad. Other important strikes occurred in construction, forest industries and iron mining—the latter contributing to a sharp decline in mining output in the third quarter. The final quarter of the year was relatively free of work stoppages.

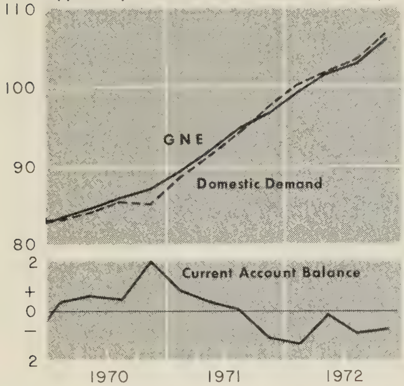
SELECTED INDICATORS

Seasonally Adjusted

GROSS NATIONAL EXPENDITURE

Current Prices

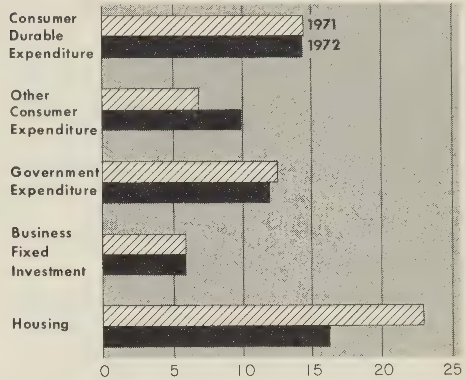
(quarterly at annual rates - billions of dollars)



INCREASES IN DOMESTIC DEMAND

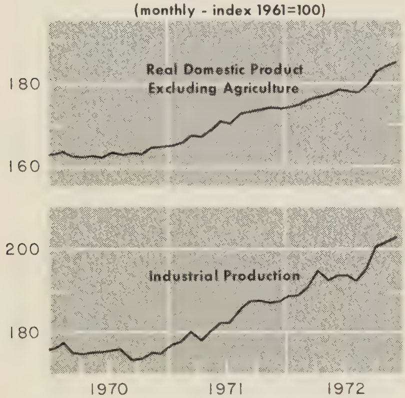
Current Prices

(annual percentage change)



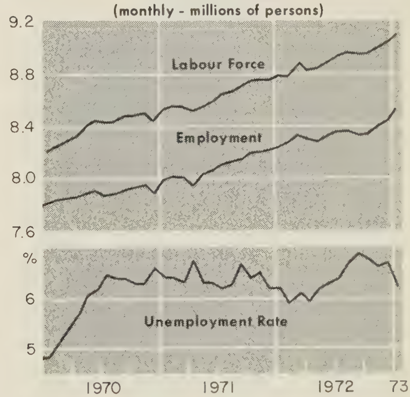
REAL OUTPUT

(monthly - index 1961=100)



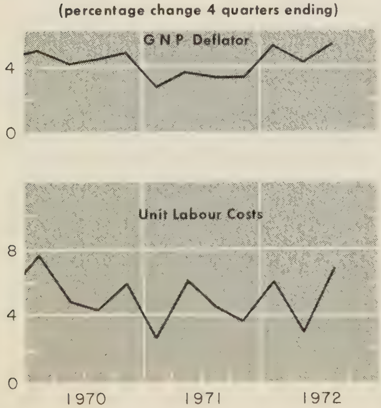
LABOUR MARKET

(monthly - millions of persons)



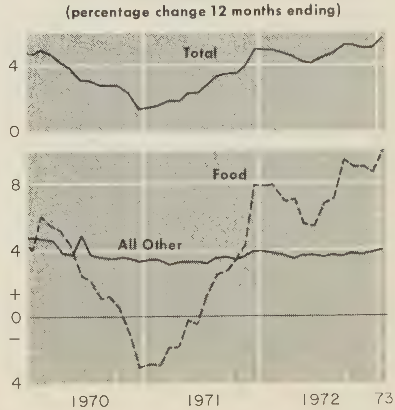
PRICES AND COSTS

(percentage change 4 quarters ending)



CONSUMER PRICES

(percentage change 12 months ending)



Developments of this kind contributed to a temporary interruption of the expansion of the economy during the summer. The first official national accounts estimates actually showed a decline in real GNP during the third quarter, although subsequent revisions to balance of payments data now suggest that the decline may have been very slight. In any event, this hesitation was followed by a strong rebound in output in the closing months of the year. The gain in real GNP in the fourth quarter was undoubtedly very strong. An alternative measure of output, the index of real domestic product, rose by about 3 per cent from the third to the fourth quarter. Industrial production rose by 4 per cent over the same period and in December was more than 8 per cent higher than a year earlier. While the very large rise in industrial output after August owed something to post-strike recoveries, it is noteworthy that the gains were widely dispersed among industries.

For the year as a whole domestic demand, that is the combined outlays of consumers, governments and business, is estimated to have risen by nearly 11 per cent in money terms, about one per cent more than in the previous year. After allowing for the greater rise in prices in 1972 the increase in the volume of domestic demand was close to 6 per cent, about the same as in 1971.

Most sectors of domestic demand, with the notable exceptions of non-residential construction and inventories, were quite buoyant during the year. Personal consumption expenditures, particularly on new cars and other durables, registered a very strong gain. Sales of new cars, both North American and overseas models, reached a new record, while sales of colour television sets approximately doubled.

House building also continued at a very fast pace, though the amount of new stimulus coming from this sector had tapered off before the end of the year; 250,000 new housing units were started in 1972 compared with the previous year's record of 234,000 units. Individual houses rather than apartments again accounted for an unusually high proportion of this construction activity. A record level of housing completions in 1972 undoubtedly stimulated consumer purchases of furniture and other household durables.

As in the previous year spending by governments continued to rise strongly. Direct demand for goods and services apparently increased by about 12 per cent at both the federal and provincial-municipal levels. In addition federal Government transfer payments to persons, particularly unemployment insurance payments, rose much faster.

Business investment in fixed capital is one of the more difficult elements of the picture for 1972 to assess at the present time, but it seems that the total of such outlays may have increased no more than in 1971. Non-residential construction may have declined slightly in volume terms, partly because of delays due to labour disputes. In the case of machinery and equipment there were

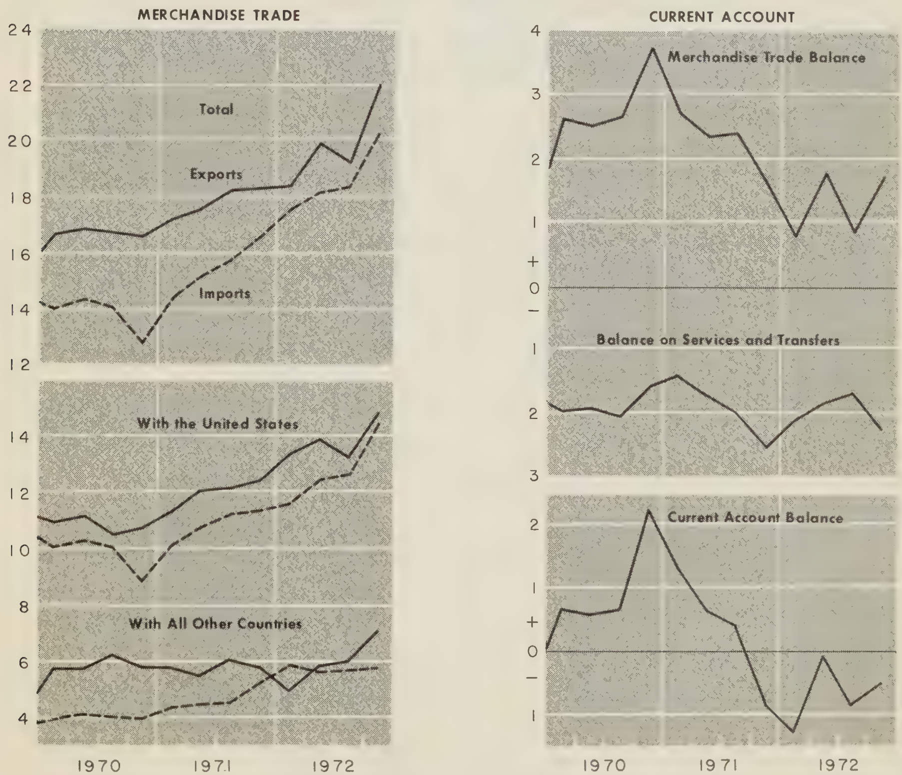
sizeable increases in imports and in shipments by domestic manufacturers, and outlays must have exceeded the fairly modest gain anticipated at the beginning of the year. In any event, such leading indicators of investment as contract awards and orders for capital equipment suggest that prospects for business investment in the current year are quite strong.

Although there were signs that business inventories, particularly in manufacturing, were being accumulated at a faster rate than in the previous year, they seem to have remained very low in relation to sales. This may have been due in part to underestimation of demand and to work stoppages.

Between 1971 and 1972 the current account of the balance of payments swung from a surplus of about $400 million (balance of payments basis) to a deficit of about $670 million, a negative movement equivalent to a one per cent reduction in GNP. This swing was almost entirely attributable to a reduction in our surplus on merchandise trade. Merchandise exports rose by 12 per cent,

CURRENT ACCOUNT OF THE BALANCE OF PAYMENTS

Quarterly - Billions of Dollars



Seasonally adjusted at annual rates.

more strongly than in 1971, but imports rose by 20 per cent. The gain in exports was due mainly to an increase of nearly 16 per cent in exports to the United States. Exports to overseas countries rose only modestly from a year earlier, but wheat shipments picked up strongly in the second half and towards year-end other exports were also rising vigorously in response to cyclical upturns in the major overseas countries. In volume terms the rise in imports was about 16 per cent compared with the rise of some 6 per cent in domestic demand, and this strength of demand for imports was reflected across a broad range of goods. It is noteworthy that this increase in the market share of imports occurred at a time when few domestic industries appear to have been operating at capacity levels.

The growth of more than 5 per cent in real GNP in 1972 was accompanied by an increase in total employment of 250,000 or just over 3 per cent—implying a gain in productivity roughly equal to the longer-term average. Non-farm employment increased by 3¾ per cent, but this gain was partly offset by a decline of almost 6 per cent in farm employment. As usual, employment of young people aged 14-24 grew relatively rapidly (by over 5 per cent) as did that of adult women (by 3¾ per cent). Employment of men 25 years of age and over grew strongly in the early months of the year but for the year as a whole it averaged less than 2 per cent higher than in 1971.

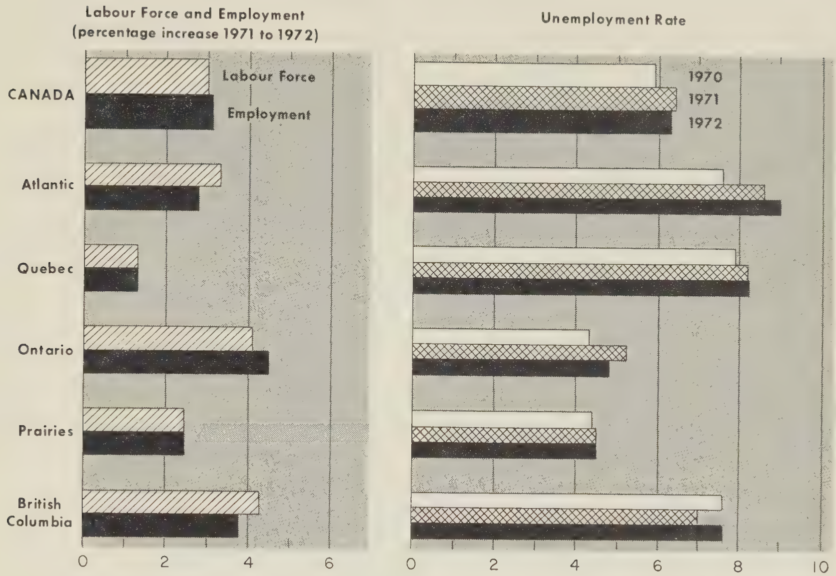
The increase in the population of labour force age was slightly lower than in the previous year, but the proportion participating in the labour force rose from just over 56 per cent to 56½ per cent. Consequently the rise in the labour force was again about 3 per cent, a little more than might have been anticipated on the basis of projected trends for the first half of this decade. As in the case of employment, the rate of increase of the labour force recorded for women and young people was appreciably faster than for men.

With similar rates of increase in employment and in the labour force, the unemployment rate in 1972 averaged 6.3 per cent, almost as high as in 1971. In the early months of the year the seasonally adjusted rate was around 6 per cent but it rose to a peak of 6.9 per cent at the end of the summer; it was still close to this level at year-end but then dropped back to 6.2 per cent in January 1973, the same as a year earlier.

The only region to show a reduction in the average unemployment rate in 1972 was Ontario, where, despite a substantial increase in the labour force, an unusually large gain in employment of 4½ per cent was sufficient to reduce the unemployment rate from an average of 5¼ per cent in 1971 to an average of 4¾ per cent in 1972. In Quebec, where increases in the labour force and employment were again below the national average, the unemployment rate in 1972 was close to 8¼ per cent for the second year running. In the Prairie region the increase in employment in 1972 was matched by the increase in the

REGIONAL LABOUR MARKET INDICATORS

Annual Averages



labour force, and the unemployment rate averaged 4½ per cent, the same as in 1971. Although employment in the Atlantic region showed the strongest gain since the mid-1960s, an even larger increase in the labour force resulted in the unemployment rate rising to 9 per cent. In British Columbia, which has typically had much higher rates of labour force growth than other parts of the country, the increase in the labour force in 1972 was again somewhat less than normal for the second consecutive year; however, at less than 4 per cent the gain in employment was also relatively moderate and the unemployment rate moved up to 7½ per cent.

As pointed out earlier, the interpretation of the unemployment statistics has become more difficult, particularly over the past year or so since the introduction of unemployment insurance benefits that are substantially larger and available for more extended periods than before. It seems paradoxical that there should be at one and the same time persistently high unemployment figures and evidence of growing difficulties in finding many kinds of labour to fill available jobs. Such evidence not only takes the form of widespread reports from employers but also is reflected in the relatively new data on job vacancies, which show that in the third quarter of 1972 total vacancies were almost twice as high as a year earlier.

Despite the degree of underutilization of resources, the rate of price increase showed unmistakable signs of acceleration in 1972. The sharpest rise occurred

in food prices, which are always subject to the vagaries of weather and other factors affecting world supply and demand. This development poses a serious threat to wage and price behaviour generally, because of its marked impact on the cost of living, particularly of lower income groups. Many foodstuffs, including fruits, vegetables, eggs, sugar and coffee, registered sharp price increases but much of the pressure was centred on meat. A world-wide shortage of beef contributed to an increase in retail beef prices of close to 10 per cent for the second year running, while the price of pork rose by more than 25 per cent. In January 1973 the food component of the Consumer Price Index was 10 per cent higher than a year earlier, the largest increase for many years. Other consumer prices rose about 4 per cent and the annual rate of increase in recent months, after allowance for seasonal factors, has been close to 4½ per cent.

There has also been substantial upward pressure on the prices of a number of other important internationally-traded commodities, including lumber, petroleum products, wool, and hides. This has contributed to a more rapid rate of increase in Canadian wholesale and industry selling prices. In particular, the sharply higher cost of lumber was mainly responsible for an increase in the index of residential building materials of about 15 per cent during 1972.

The GNP deflator for the whole economy apparently averaged at least 4½ per cent higher in 1972 than in 1971. Profits per unit of output averaged considerably higher than in 1971, and the increase in unit labour costs was also substantial; productivity gains appear to have been moderate, while income per worker continued to rise strongly. New wage settlements under collective bargaining (excluding construction) again provided for average annual increases in earnings of over 7½ per cent and in manufacturing the figure was closer to 9 per cent. Thus increases in incomes have continued to exceed the average gain in productivity by a margin that is inconsistent with what has generally been regarded in the past as a satisfactory price performance.

Bank of Canada Operations

The broad lines of monetary policy in 1972 have been discussed earlier in this Report. This section provides additional details on the cash management and securities market operations of the Bank of Canada and on the activities of the Bank as agent for the Government on behalf of the Exchange Fund Account and in the management of the public debt.

CASH MANAGEMENT AND OPERATIONS IN THE SECURITIES MARKET. During 1972 Bank of Canada cash reserve management was designed to provide the banking system with reserves sufficient to accommodate a rapid expansion of credit while not encouraging the banks to add to their holdings of liquid assets. In the course of the year, particularly during the first half, cash management was adjusted from time to time with a view to dampening the impact of pressures that developed in financial markets.

The secondary reserve requirement, which had been reduced on December 1, 1971 from 9 per cent to 8½ per cent, was further reduced to 8 per cent on January 1, 1972. There have been no subsequent changes in the secondary reserve requirement. Bank Rate has remained at 4¾ per cent as established on October 25, 1971.

The record of the chartered banks' cash reserve position during 1972 is presented in Appendix Table I. It should be noted that the short-run impact of a particular level of total cash reserves on the banking system, and on financial markets generally, depends on a variety of factors, including such rather technical considerations as the distribution of reserves among banks as well as more pervasive forces such as the strength of credit demands and the state of expectations about the economy and financial markets. Since these factors change, sometimes quite abruptly, a particular level of cash reserves will not always be associated with the same response in financial markets.

In late 1971 and early 1972 relatively low excess cash reserves were made available to the banks and, with loans rising very rapidly, their holdings of liquid assets declined from early December until the latter part of February. The two reductions in the secondary reserve requirements mentioned above were not intended to release bank liquidity and the size of the decline in the banks' total

holdings of earning liquid assets over this period was such that the amount held in excess of reserve requirements, that is, the "free" Canadian earning liquid assets, also declined.(1)

In December 1971, when bond yields had started to rise, the Bank of Canada bought securities in the market both to provide some support for security prices and to assist in providing cash reserves in connection with the seasonal increase in the note circulation. The Bank continued to buy securities during January and February with the principal objective of moderating the upward movement of interest rates. The bonds purchased during this period were of relatively short maturity and at the same time the Bank bought a substantial amount of treasury bills in connection with the reductions in the chartered bank secondary reserve requirement. As interest rates rose further during the spring and early summer the Bank continued to buy securities. Although these later purchases were mostly of short-term issues, they included some long-term bonds acquired at times when the market was under particularly strong downward pressure.

By the spring of 1972 the pressures in Canadian financial markets reflecting a strong underlying demand for credit were being heightened by the very aggressive competition for funds among the chartered banks. In addition to running off domestic liquid assets and drawing substantially on foreign sources of funds, the banks were bidding up the rates paid on their short-term deposits; by mid-May they were offering rates on large deposits in excess of their prime lending rates. The Bank of Canada had eased the cash reserves of the banking system in order to alleviate these pressures and, following the implementation on June 12 of the agreement among banks to limit the rates paid on large short-term deposits, the Bank maintained relatively easy cash reserve levels for a time and purchased bonds in the market in order to facilitate the adjustment to the new situation. The Bank was particularly concerned that banks might respond to the impending maturity of large amounts of short-term deposits by drawing further on foreign sources of funds. In the event, interest rates in the money market came down in line with the newly agreed structure of bank deposit rates and the reallocation of business between the banks and other parts of the financial system was accomplished smoothly. By the end of July the Bank of Canada had gradually returned to tighter cash settings in line with the continuing policy of keeping firm control over bank liquidity, and this posture has since been maintained. There was an increase in chartered bank liquidity during the autumn, but since early December bank holdings of liquid assets have declined again to roughly the level that prevailed during the summer of 1972.

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(1) In addition to the traditional earning liquid assets included in these measures (that is, treasury bills, day-to-day loans, call loans and Government of Canada bonds) banks hold a relatively small amount of other short-term assets as part of the liquid portion of their total portfolio of assets. Data on these holdings of commercial paper and similar instruments are now published regularly by the Bank of Canada.

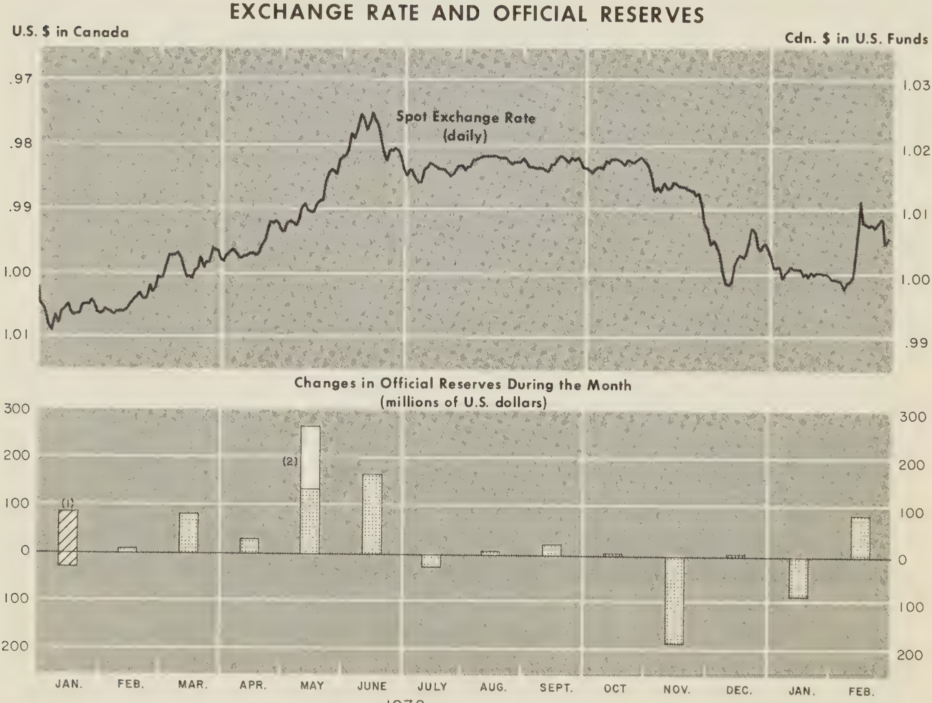
The monthly record of Bank of Canada transactions in Government of Canada securities during 1972 is presented in Appendix Table II. In the course of the year, the par value of the Bank's holdings of Government of Canada securities rose by $588 million, reflecting net transactions with Government and other client accounts, changes associated with new issues of treasury bills and bonds and open market operations. In its open market operations, the Bank made net treasury bill purchases of $337 million and Government of Canada bond purchases of $543 million. As already noted, these purchases served on occasion to moderate pressures in securities markets, as well as contributing to the management of chartered bank cash reserves. The purchases of relatively short-term bonds also assisted in the management of the public debt by reducing the amount of issues held outside the Bank of Canada at the time of their maturity. During the first part of the year this debt management objective was reflected particularly in acquisitions of the 4¼ per cent bonds that matured on September 1, 1972. In the latter part of the year the acquisition from the market of bonds due to mature early in 1973 in exchange for somewhat longer-term issues also assisted debt management.

The Bank of Canada added $191 million to its net holdings of foreign currency assets in 1972. The changes during the year in the Bank's net foreign currency position, shown in Appendix Table III, were largely a reflection of swap transactions with the Exchange Fund Account under which the Bank of Canada temporarily acquired foreign exchange assets subject to commitments for their resale to the Exchange Fund Account. The use of such swap arrangements assists the Bank of Canada in the management of chartered bank cash reserves by providing increased flexibility in the timing of Bank of Canada transactions in Government of Canada securities.

FOREIGN EXCHANGE OPERATIONS. In 1972 a deficit was recorded in the current account of the balance of payments after two years of surplus, but capital inflows were large enough to finance the deficit and produce a small over-all surplus. The external value of the Canadian dollar rose in the first half of the year, levelled out from late June to late October, and then declined. At year-end it was about ¾ of one per cent higher than at the beginning of the year. In January 1972 an allocation of Special Drawing Rights increased the U.S. dollar value of Canada's official international reserves by $117 million and, over the year as a whole, other transactions led to an increase of $229 million. In addition the revaluation of gold-based reserves in May added a further $134 million to the U.S. dollar value of reserves. There was no allocation of SDRs at the beginning of 1973.

Over the course of 1972 the Bank of Canada operated on behalf of the Exchange Fund Account to maintain orderly conditions in the exchange market. During the first two months of the year the exchange rate for the Canadian dollar fluctuated very little and there was no significant change in international reserves apart from the allocation of SDRs in January. In March there was a brief flurry in international exchange markets as the value of the U.S. dollar weakened against most major currencies and the exchange reserves rose. The Canadian dollar began to move upward again in late April, a trend that continued until mid-June, and reserves rose further. Both domestic and external forces contributed to this strength in the Canadian dollar. As mentioned earlier there was a sharp increase in Canadian long-term borrowing in foreign markets, and short-term foreign investment in Canada was attracted by the high level of short-term rates prior to the agreement among banks to limit the rates offered on their deposits. For a brief period in June, the Canadian dollar felt some of the repercussions of the unsettled conditions in international exchange markets when sterling came under severe pressure before it was allowed to float.

EXCHANGE RATE AND OFFICIAL RESERVES



(1) Includes an allocation of 117 million SDRs in January 1972.

(2) Includes an increase of U.S. $134 million resulting from the revaluation of gold-based assets.

For the next four months there was little change in the Canadian exchange rate and in official reserves. From late October to the first part of December the value of the Canadian dollar declined and the Bank of Canada again intervened in the market on behalf of the Exchange Fund Account, this time selling U.S. dollars and reducing reserves. The Canadian dollar rose in mid-December, declined over the year-end, and then remained relatively close to parity with the U.S. dollar until the U.S. dollar was devalued by 10 per cent on February 12. For two days thereafter the Canadian dollar was very strong, but by the end of February both the exchange rate and the reserves were again about where they had been at the end of 1972.

DEBT MANAGEMENT OPERATIONS. The federal Government's net financing requirement, as measured by changes in the amount of Canadian dollar securities outside Government accounts less changes in the Government's cash balances, decreased from \$2.2 billion in 1971 to \$1.4 billion in 1972. As in the previous year, the sale of Canada Savings Bonds accounted for most of the net borrowing undertaken in 1972. The outstanding amount of treasury bills increased by \$330 million. Net sales of Government marketable bonds played only a minor role in financing as the outstanding amount increased by only \$57 million compared with just under \$300 million in 1971. Appendix Table IV summarizes details of the financing operations of the Government of Canada in 1972, excluding the regular weekly issues of three-month and six-month treasury bills.

The 1972/73 series of Canada Savings Bonds offered investors an average yield of 7.30 per cent over a twelve-year term and included an interest compounding option. Net sales during the fourth quarter of 1972 amounted to \$1.7 billion and at the end of the year the outstanding amount of Canada Savings Bonds was \$1.2 billion higher than a year earlier.

The outstanding amount of treasury bills did not change during the first three months of 1972. At each of the weekly auctions from April 6 to June 22 there was an addition of \$5 million to the issue of treasury bills and from June 29 until the end of the year \$10 million was added at each weekly auction.

The Government of Canada borrowed in the domestic bond market on four occasions in 1972, mainly to refund maturing issues. Offerings of Canadian dollar direct marketable bonds were \$1,450 million while retirements and cancellations amounted to \$1,393 million. The new loans were of short- and medium-term maturity, and the average term of outstanding unmatured marketable direct and guaranteed bonds shortened over the year by eight months to five years and nine months.

An advance refunding of the 4¼ per cent bonds due September 1, 1972 was included as an option in the July 1, 1972 debt operation. The new bonds were offered to investors for cash or in exchange for the approaching September 1, 1972 maturity. Of the $717 million 4¼ per cent September 1, 1972 bonds then outstanding, $263 million were exchanged leaving $455 million for retirement on September 1.

Bonds with extendible options were offered in both the July pre-refunding and the September redemption of the 4¼ per cent bonds. On each of these occasions the offering included a 7 per cent bond maturing July 1, 1977, convertible into a 7½ per cent bond maturing July 1, 1982. In total $650 million of these extendible bonds were issued.

Appendix Tables I to IV ▶

APPENDIX TABLE I

CHARTERED BANK CASH RESERVES – 1972

(millions of dollars, unless otherwise indicated)

	Requirements						
	Total cash requirements	Average Bank of Canada notes	Required Bank of Canada deposits	Average holdings of Bank of Canada deposits	Excess cash reserve ratio	Cumulative excess reserves for the period	Number of statutory days
Jan. 1-15	2,266	624	1,642	1,669	0.08	242	9
16-31				1,664	0.07	248	11
Feb. 1-15	2,281	709	1,572	1,597	0.07	270	11
16-29				1,609	0.10	363	10
Mar. 1-15	2,217	633	1,584	1,619	0.10	383	11
16-31				1,619	0.10	374	11
Apr. 1-15	2,214	615	1,599	1,635	0.10	356	10
16-30				1,636	0.10	362	10
May 1-15	2,212	638	1,574	1,605	0.09	343	11
16-31				1,607	0.09	363	11
June 1-15	2,262	676	1,586	1,624	0.10	413	11
16-30				1,621	0.09	385	11
July 1-15	2,251	722	1,529	1,567	0.10	341	9
16-31				1,560	0.08	337	11
Aug. 1-15	2,285	741	1,544	1,572	0.08	314	11
16-31				1,566	0.06	265	12
Sept. 1-15	2,271	725	1,546	1,575	0.08	291	10
16-30				1,574	0.07	275	10
Oct. 1-15	2,285	715	1,570	1,600	0.08	268	9
16-31				1,604	0.09	401	12
Nov. 1-15	2,300	719	1,581	1,607	0.07	260	10
16-30				1,609	0.07	300	11
Dec. 1-15	2,404	721	1,683	1,705	0.06	242	11
16-31				1,718	0.09	275	8

APPENDIX TABLE II

BANK OF CANADA NET TRANSACTIONS IN GOVERNMENT OF CANADA SECURITIES IN 1972

(delivered basis — par value in millions of dollars)

	Net purchases from (+) or net sales to (−) investment dealers and banks[1]						
		Bonds[2]					
	Treasury bills	3 years & under	3 years to 5	5 years to 10	Over 10 years	Sub-total bills and bonds	Securities under PRA
Jan.	+102	+ 76	+ 1	−1	–	+177	+121
Feb.	+ 62	+ 44	+17	–	–	+122	−121
Mar.	− 2	+ 23	–	–	+ 5	+ 26	–
Apr.	+ 37	+ 21	+27	–	+26	+110	–
May	+ 15	+116	–	–	+ 1	+132	+ 11
June	–	+ 26	+25	–	+ 3	+ 54	− 12
July	+ 41	+ 22	− 6	–	+ 4	+ 61	+ 9
Aug.	+ 41	–	–	–	–	+ 41	+ 16
Sept.	+ 24	+ 65	–	–	–	+ 89	− 26
Oct.	–	–	–	–	–	–	–
Nov.	+ 11	–	–	–	–	+ 11	+223
Dec.	+ 6	+ 52	− 3	–	–	+ 56	−223
Total	+337	+444	+61	−1	+39	+880	–

(1) Advances by the Bank of Canada to the chartered banks were outstanding on 19 business days. Purchase and resale agreements with money market dealers were outstanding on 115 business days. Over the year as a whole, the average daily amount of advances outstanding was $706,000. The average daily amount of securities held by the Bank of Canada under PRA was $17.1 million. A one-day high of $259.3 million in PRA outstanding was recorded on November 30.
(2) Classified by years to maturity at time of transactions.

Net transactions with Government and other client accounts						Net change in holdings of Government of Canada securities		
Purchases (+) of new issues less matured holdings		Net purchases from (+) or net sales to (−)						
		Securities Investment Acct.		Other Government and client accounts				
bills	bonds	bills	bonds	bills	bonds	bills	bonds	total
+ 54	–	–	–	−102	–	+100	+150	+250
+ 17	–	–	–	− 24	–	+ 8	− 15	− 6
− 21	–	–	–	− 57	–	− 79	+ 28	− 51
− 38	+21	–	–	− 49	−27	− 50	+ 67	+ 18
+ 33	–	–	–	− 36	−20	+ 17	+103	+119
− 48	–	–	–	− 40	− 1	− 93	+ 46	− 47
+ 13	–	–	–	− 26	−11	+ 31	+ 15	+ 46
+ 29	–	–	–	− 27	− 5	+ 53	+ 2	+ 55
+ 36	+46	–	–	− 49	− 1	− 3	+ 98	+ 95
+ 52	–	–	–	− 18	− 2	+ 33	− 2	+ 31
+ 73	–	–	–	− 35	–	+151	+122	+272
+ 33	–	–	–	− 61	− 1	−122	− 73	−195
+233	+67	–	–	−523	−69	+ 47	+541	+588

APPENDIX TABLE III

BANK OF CANADA ASSETS AND LIABILITIES

(monthly changes — millions of dollars)

1972	Government of Canada securities at book value	Net foreign currency assets	Investment in IDB	All other assets (net)	Note circulation	Canadian dollar deposit liabilities: Chartered banks	Canadian dollar deposit liabilities: Government of Canada	Canadian dollar deposit liabilities: Other
Jan.	+251	−100	+ 9	− 85	−200	+212	+ 66	− 3
Feb.	− 8	− 50	+ 4	+ 1	+ 33	− 21	− 59	− 6
Mar.	− 51	+ 48	–	− 13	+ 55	− 41	− 54	+26
Apr.	+ 16	+ 34	+15	+172	+ 42	+ 62	+156	−22
May	+120	− 34	–	−172	+122	− 74	−149	+14
June	− 46	+182	+ 6	+ 26	+152	− 9	+ 21	+ 3
July	+ 47	+ 54	+ 8	+ 69	+ 74	− 20	+117	+ 6
Aug.	+ 56	− 90	+ 2	− 90	− 8	− 16	− 80	−18
Sept.	+ 97	− 99	+ 4	+104	− 8	+ 16	+100	− 2
Oct.	+ 33	+ 49	+15	− 24	+ 88	+ 42	− 58	–
Nov.	+270	− 22	+ 5	− 75	+ 45	+ 24	+107	+ 1
Dec.	−194	+219	+ 6	+126	+307	+ 51	−209	+ 9
Total	+591	+191	+72	+ 39	+703	+225	− 42	+ 8

APPENDIX TABLE IV

SUMMARY OF NEW ISSUES AND RETIREMENTS GOVERNMENT OF CANADA DIRECT AND GUARANTEED MARKETABLE SECURITIES*

Date	Issues offered	Amount delivered (millions of dollars par value)	Term to maturity	Yield to maturity	Amount retired (millions of dollars par value)
1972					
	(payable in Canadian dollars — direct)				
Feb. 11	Treasury bills	125	364 days	4.39	125
Apr. 1	5¼% Dec. 1, 1973(1)	150	1 yr. 8 mos.	5.56	
	6½% Apr. 1, 1977	225	5 yrs.	6.50	
		375			450
May 12	Treasury bills	125	364 days	4.72	125
July 1	5¾% Feb. 1, 1974	100	1 yr. 7 mos.	5.85	
	7% July 1, 1977(2)	300	5 yrs.	7.00	
		400(3)			263
Sept. 1	5¾% Feb. 1, 1974(4)	100	1 yr. 5 mos.	5.75	
	7% July 1, 1977 (5)(6)	350	4 yrs. 10 mos.	7.00	
		450			455
Nov. 24	Treasury bills	150	364 days	4.36	150
Dec. 15	6½% June 1, 1979(7)	225	6 yrs. 5½ mos.	6.55	225
	Total bonds	1,450			1,393
	Total treasury bills*	400			400
	(payable in Canadian dollars — guaranteed)				
Dec. 29					7(8)
	(payable in foreign currencies)				
Apr. 15					1(9)
Oct. 15					1(9)

* Excludes three-month and six-month treasury bills.
(1) In addition to $150 million 5¼% December 1, 1973 already outstanding.
(2) Convertible at option of holder from July 1, 1976 to December 31, 1976 into an equal par value of 5 year 7½% bonds dated July 1, 1977 and due July 1, 1982 giving a combined average yield of 7.21% for the full 10-year period commencing July 1, 1972.
(3) Offered in exchange for equal par value of Government of Canada 4¼% bonds due September 1, 1972, or for cash.
(4) In addition to $100 million 5¾% February 1, 1974 already outstanding.
(5) Convertible at option of holder from July 1, 1976 to December 31, 1976 into an equal par value of 5 year 7½% bonds dated July 1, 1977 and due July 1, 1982 giving a combined average yield of 7.21% for the full 9-year, 10-month period commencing September 1, 1972.
(6) In addition to $300 million 7% July 1, 1977 already outstanding.
(7) In addition to $100 million 6½% June 1, 1979 already outstanding.
(8) Cancellation by purchase funds of the following Canadian National Railway bonds: $1.4 million of 5% May 15, 1977; $2.0 million of 5¾% January 1, 1985; $3.4 million of 5% October 1, 1987.
(9) Partial redemption at par of U.S.-pay 5% October 15, 1987 for Sinking Fund.

BANK OF CANADA STATEMENT OF INCOME AND EXPENSE

YEAR ENDED DECEMBER 31, 1972
(with comparative figures for 1971)

(thousands of dollars)

	1972	1971
Income		
Revenue from investments and other income	$330,981	$292,583
Expense		
Salaries[1]	$ 10,301	$ 8,985
Contributions to pension and insurance funds	2,348	2,423
Other staff expenses[2]	908	624
Directors' fees	27	29
Auditors' fees and expenses	124	124
Taxes – municipal and business	1,767	1,579
Bank note costs	8,195	7,138
Data processing and computer costs	702	558
Maintenance of premises and equipment – net	1,674	2,260
Printing of publications	396	224
Other printing and stationery	333	301
Postage and express	325	316
Telecommunications	340	291
Travel and staff transfers	419	296
Interest on unclaimed balances	103	92
Other	496	466
	$ 28,458	$ 25,706
Depreciation of buildings and equipment	1,450	1,383
Net Income Paid to Receiver General for Canada	301,073	265,494
	$330,981	$292,583

(1) The number of staff averaged 1,169 in 1971 and 1,242 in 1972.
(2) Includes overtime pay, medical services and cafeteria expenses.

ASSETS

	1972	1971
Deposits in foreign currencies:		
Pounds sterling and U.S.A. dollars	$ 53,672	$ 42,904
Other currencies	322	232
	53,994	43,136
Cheques on other banks	395,886	306,802
Advances to chartered and savings banks	1,900	2,000
Accrued interest on investments	94,915	74,225
Bills bought in open market, not including treasury bills, at cost		997
Investments — at amortized values:		
Treasury bills of Canada	932,110	885,232
Other securities issued or guaranteed by Canada maturing within three years	2,053,310	1,769,770
Other securites issued or guaranteed by Canada not maturing within three years	2,421,515	2,160,511
Debentures issued by Industrial Development Bank	527,109	457,874
Securities issued by the United Kingdom and the United States of America	414,000	214,513
Other securities	2,633	2,633
	6,350,677	5,490,533
Industrial Development Bank:		
Total issued share capital, at cost (note)	59,000	56,000
Bank premises:		
Land, buildings and equipment Cost less accumulated depreciation	23,106	22,206
Net balance of Government of Canada collections and payments in process of settlement	75,500	21,376
Other assets	1,346	1,506
	$7,056,324	$6,018,781

AS AT DECEMBER 31, 1972
(with comparative figures as at December 31, 1971)
(thousands of dollars)

LIABILITIES

	1972	1971
Capital paid up	$ 5,000	$ 5,000
Rest fund	25,000	25,000
Notes in circulation	4,806,242	4,103,423
Deposits:		
Government of Canada	26,658	68,365
Chartered banks	1,697,893	1,472,816
Other	52,280	43,964
	1,776,831	1,585,145
Liabilities in foreign currencies:		
Government of Canada	57,760	38,750
Other	226	304
	57,986	39,054
Bank of Canada cheques outstanding	382,408	257,621
Other liabilities	2,857	3,538
	$7,056,324	$6,018,781

Note: The audited financial statements of the Industrial Development Bank as of September 30, 1972 show an equity of $84,830,549 at which date the Bank of Canada's investment in the share capital was $58,000,000.

G. K. BOUEY, Governor

A. ROUSSEAU, Chief Accountant

Auditors' Report ● We have examined the statement of assets and liabilities of the Bank of Canada as at December 31, 1972 and the statement of income and expense for the year then ended. Our examination included a general review of the accounting procedures and such tests of accounting records and other supporting evidence as we considered necessary in the circumstances.

In our opinion these financial statements present fairly the financial position of the Bank as at December 31, 1972 and the results of its operations for the year then ended.

G. PRÉFONTAINE, C.A.
of Séguin, Ménard, Patenaude,
Préfontaine & Cie.

A. J. LITTLE, F.C.A.
of Clarkson, Gordon & Co.

Ottawa, Canada, January 25, 1973.

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